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n Canada's Economic Prospects

Certain Aspects of Taxation Relating to Investment in Canada by Non-Residents

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ROYAL COMMISSION ON CANADA'S ECONOMIC PROSPECTS

CERTAIN ASPECTS OF TAXATION RELATING TO INVESTMENT IN CANADA BY NON-RESIDENTS

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While authorizing the publication of this study, which has been prepared at their request, the Commissioners do not necessarily accept responsibility for all the statements or opinions that may be found in it.

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1

THE STATISTICAL BACKGROUND

Foreign Investment in Canada

The statistical data available as to foreign investment in Canada indicate that not only are the amounts involved substantial, but that they have increased rapidly in recent years.

The attached Appendix B has been prepared from data published by the Dominion Bureau of Statistics and shows for selected years (1939, 1945, 1949, and 1953) the total investment in Canada of non-residents, classified by type of security. This investment is further analyzed to show separately the amounts thereof owned by residents of the United States, the United Kingdom and all other countries. The information contained in Appendix B is summarized below:

(a) *Amounts of foreign capital invested in Canada:*

INVESTMENTS IN CANADIAN CORPORATIONS	MILLIONS OF DOLLARS			
	1939	1945	1949	1953
DIRECT (controlled in country of ownership)	$2,296	$2,713	$3,586	$5,977
PORTFOLIO INVESTMENT	2,629	2,433	2,317	2,894
TOTAL	$4,925	$5,146	$5,903	$8,871
GOVERNMENT AND MUNICIPAL BONDS	1,703	1,662	1,755	2,087
MISCELLANEOUS INVESTMENTS	285	284	302	466
TOTAL NON-RESIDENT INVESTMENTS	$6,913	$7,092	$7,960	$11,424

This table discloses the rising trend of total foreign investment in Canada. There was little increase in the six years 1939 to 1945 ($179 million) and a moderate increase in the four years 1945 to 1949 ($868 million). During the following four years 1950-53 a very rapid increase occurred, amounting to $3,464 million or 43% of the 1949 figure. This trend is evidently continuing and preliminary estimates for 1954 shown on the attached Appendix B indicate a further increase of 8% in the United States investment in Canada in that year.

(b) *Ownership of foreign investment:*

Investments owned in the United States and the United Kingdom have since 1939 comprised the major portion of total direct investment in Canada, representing well over 90% of the total in each of the years shown. The proportion held by United States owners has increased steadily from 60% in 1939 to 77% in 1953 and amounted at the latter date to $8,840 million. The United Kingdom investment actually declined from $2,476 million in 1939 to $1,750 million in 1945 and while there has been a resumption of investment, resulting in an increase of almost $300 million in the four years 1950-53, the United Kingdom proportion of total foreign investment in Canada declined from 36% in 1939 to 18% in 1953.

(c) *Increase in "direct" investment:*

The most striking aspect of these investment changes is the increase in direct investment in corporations, which by 1953 had grown to approximately 2½ times the 1939 figure. In the eight postwar years, 1946-53, this class of investment more than doubled. In 1939 direct investment in corporations accounted for 33% of the total non-resident investment, while in 1953 it had increased to 52% of the total investment. This trend is found in both the United States and the United Kingdom investments. The United States direct investment, as a percentage of total United States investment, increased from 45% in 1939 to 59% in 1953 and the corresponding increase in the United Kingdom percentages was from 15% to 30%.

The term "direct investment" is defined by the Dominion Bureau of Statistics as the holdings of equity capital, funded debt and other long term indebtedness by *all* residents of a foreign country where 50% or more of the voting stock is owned in that country. (In occasional instances where minority holdings are known to constitute control, these are also included in the total of direct investment). "Portfolio" investment represents the total investment where less than control is held in such country. The "direct" investment may be held by numerous owners in the foreign country and it does not follow that in all cases control was held by a single corporation, individual or small group. However, the greater part of this "direct" total evidently represents controlling interests: data available for the year 1950 indicate

that of the total United States direct investment in Canadian corporations for that year ($3,579 million), only about 20% ($769 million) represents the holdings of United States owners not affiliated with the controlling interest or group. The interest of non-United States investors (including Canadian minorities) in these corporations in the same year amounted to $1,010 million.

(d) *Portfolio investment:*

In contrast to the striking increase which has taken place in direct investment, the total of portfolio investment by non-residents is practically unchanged, viz. $2,894 million in 1953 as compared with $2,629 million in 1939. Compulsory conversion of the holdings of residents of the United Kingdom during the war was primarily responsible for a reduction during the 14-year period of approximately $400 million in United Kingdom holdings from the $1,537 million held at the beginning of the war. In the same period portfolio investment by United States residents increased from $944 million to $1,534 million—almost all of which is represented by increased holdings of capital stock, investment in bonds and debentures being relatively unchanged.

(e) *Direct investment classified by industry:*

Appendix C summarizes data provided by the Dominion Bureau of Statistics as to the investment by United States and United Kingdom holders, classified by type of industry. The more important points disclosed by this analysis are:

> The proportions and rate of growth of United States investment in non-metallic minerals manufacturing and mining and smelting which amounted in 1953 to $505 million and $1,104 million respectively. These classes, which include investment in the petroleum industry, have increased almost fivefold since 1939.
>
> The importance of investment by United States holders in non-ferrous metals manufacturing, iron ore products manufacturing and the manufacture of wood and paper products.
>
> The lack of any substantial increase in investment in public utilities by United States holders.
>
> The absence of any significant investment by United Kingdom holders in mining or manufacture of non-metallic minerals. The more important United Kingdom avenues of investment are wood and paper products and merchandising.

Statistics published by the United States Department of Commerce show for 1954 separate totals of United States investment in certain industries in Canada, including the petroleum industry.

CANADIAN INDUSTRIES	AMOUNT OF UNITED STATES *DIRECT* INVESTMENT IN 1954
	(MILLIONS OF DOLLARS)
PETROLEUM	$1,160
MINING AND SMELTING	783
ALL MANUFACTURING	2,553
PUBLIC UTILITIES	301
TRADE	358
OTHER INDUSTRIES	784
TOTAL *DIRECT* INVESTMENT	$5,939

(f) *Proportion of certain Canadian industries owned by non-residents:*

There are no comprehensive statistics available to indicate the total investment by various classifications of Canadian industry against which the investment of non-residents referred to above could be compared. The Dominion Bureau of Statistics has, however, published a brief summary outlining the Bureau's estimate of the non-resident interest in the ownership of several selected classes of Canadian industry as follows:

	PERCENTAGE OF TOTAL OWNED BY							
	ALL NON-RESIDENTS				UNITED STATES RESIDENTS			
	1939	1948	1951	1952	1939	1948	1951	1952
*MANUFACTURING	42%	42%	44%	46%	34%	36%	36%	38%
*MINING, SMELTING AND PETROLEUM EXPLORATION AND DEVELOPMENT	40	42	59	59	31	35	52	53
STEAM RAILWAYS	57	43	39	37	18	21	18	17
OTHER UTILITIES	27	21	20	20	20	17	17	17
TOTAL OF ABOVE INDUSTRIES AND MERCHANDISING BUSINESSES	38	33	32	33	22	24	24	25

* Investment in exploration and development of petroleum by companies engaged principally in refining and production of petroleum products in Canada are included in manufacturing.

The investment on which these percentages are based is not confined to interests in corporations. Publicly owned enterprises and unincorporated ventures are also included. As the Bureau points out, there are many types of predominantly Canadian-owned capital which are not covered in this summary, such as farm and residential property and federal, provincial and municipal assets not falling within the specific categories shown.

(g) *Importance of investment in Canada in relation to the total of United States foreign direct investment.*

Investment in Canada looms large in the total of United States direct investment abroad. Estimates published by the United States Department of Commerce indicate total United States "direct" investment abroad at the end of 1954 of $17,748 million, of which the amount invested in Canada was $5,939 million or one-third of the total. It also ranks as by far the most important site of all United States foreign investment, being more than four times the next largest, Venezuela, in which the total of direct investment was $1,399 million.

Canadian Investment in Foreign Countries

In order to lend some perspective to the previous discussion of foreign investment in Canada, there follows a summary of Canadian investment abroad (excluding Government of Canada credits) at selected year-ends:

	(MILLIONS OF DOLLARS)			
	ALL COUNTRIES	UNITED STATES	UNITED KINGDOM	OTHER COUNTRIES
DIRECT CANADIAN INVESTMENT IN BRANCHES, SUBSIDIARIES AND CONTROLLED COMPANIES–				
1939	$ 671	$ 412	$ 59	$200
1945	720	455	54	211
1949	926	721	59	146
1953	1,507	1,147	104	256
PORTFOLIO INVESTMENTS IN FOREIGN SECURITIES–				
1939	719	501	43	175
1945	621	409	53	159
1949	638	443	40	155
1953	842	537	29	276
TOTAL DIRECT AND PORTFOLIO INVESTMENT				
1939	1,390	913	102	375
1945	1,341	864	107	370
1949	1,564	1,164	99	301
1953	2,349	1,684	133	532

NOTE: (Sizeable Canadian interests in utilities in Latin America and South America are considered *portfolio* investment in this table.)

SOURCE: The Canadian Balance of International Payments, 1954 and International Investment Position – Dominion Bureau of Statistics.

Some of the trends indicated by this table are referred to below:

(a) *Trend of Canadian private investment abroad:*

Since 1939 the trend of growth of private Canadian investment in foreign countries roughly corresponds to the pattern of foreign investment in Canada. There was a minor reduction in the years 1939 to 1945 and a moderate growth from $1,341 million in 1945 to $1,564 million in 1949. In the period 1949 to 1953 Canadian investment in foreign countries increased sharply to a total of $2,349 million.

(b) *Countries in which investment made:*

Investment in the United States is far in excess of that in all other countries and has become increasingly important, growing from 66% of total investment abroad in 1939 to 72% in 1953.

(c) *Direct vs. portfolio investment:*

The increasing proportion of total investment represented by "direct" investment is another point of similarity between Canadian investment abroad and foreign investment in Canada. Direct investment which represented only 48% of total investment abroad in 1939 has increased to 64% in 1953, while portfolio investment abroad has increased very little.

(d) *Direct investment classified by industry:*

The following summarizes the available data as to investment by class of industry, as at December 31, 1953:

DIRECT INVESTMENT CLASSIFIED BY INDUSTRY	ALL COUNTRIES	UNITED STATES	UNITED KINGDOM	OTHER COUNTRIES
	MILLIONS OF DOLLARS			
Railways and Utilities	$ 402	$ 365	$ 1	$ 36
Industrial and Commercial	879	652	103	124
Mining and Petroleum	217	123		94
Other Concerns	9	7		2
TOTAL DIRECT INVESTMENT	1,507	1,147	104	256

More than 58% of all Canadian direct investment abroad at the end of 1953 was in industrial and commercial ventures. The only other types of industry of significance were railways and utilities in the United States, and the mining and petroleum industries in the United States and other countries apart from the United Kingdom.

2

FACTORS OTHER THAN CANADIAN TAXATION AFFECTING INVESTMENT

Non-tax Factors Affecting Foreign Investment in Canada

Among the factors which affect private international investment certain fundamental considerations, such as safety and future prospects in general, exert a preponderant influence. Thus in reviewing the reasons for the substantial influx of foreign capital into Canada in the past decade, certain positive attractions possessed by Canada as a field for investment appear clearly to outweigh tax considerations. Indeed, experience and recent enquiries of banks, government agencies and professional advisors abroad indicate that in many cases foreign investors have actually made their investment in Canada before making any particular enquiries as to the Canadian scheme of taxation. While the favourable reputation which Canada enjoys throughout the world implicitly carries the assurance of a fair and equitable system of taxation, other and more general considerations appear to have exerted the major influence in attracting investment to Canada.

The following are among the more important of the specific attractions of Canada as a field for investment and as such have exerted a considerable influence on foreign investors:

(a) Growth prospect; the combination of a small population and large land areas possessing great potential wealth gives the economy a vigorous growth characteristic.

(b) Impressive natural resources, with every prospect of important further discoveries.

(c) A well developed market which is based on a high level of national income.

(d) A stable economy, despite dependence on international trading.

(e) Democratic institutions and a long record of political stability.

(f) Sound monetary policies, a highly developed banking system and established securities exchanges.

(g) Complete freedom of movement for money and securities and no restrictions on international transfers.

(h) Low cost energy; in certain areas cheap hydro-electric power has proved particularly attractive to electro-chemical and electro-metallurgical enterprises, such as the aluminium industry.

(i) Geographical factors; Canada has a particular attraction for European investors who regard it as relatively safe, removed from the troubled political areas of the old world.

(j) Cultural and sentimental considerations; by language, culture and habit, Canada is closely tied to both the United Kingdom and the United States, the two principal exporters of capital, and it constitutes a logical extension of their markets. In the case of the United States the attraction is particularly strong by reason of propinquity and the wide and often involuntary coverage of Canadian markets by United States advertising in periodicals, television and other media.

Apart from the foregoing general non-tax considerations which motivate the foreign investor, the tax laws of his own country may serve to stimulate investment beyond is own borders. Thus, investment will go abroad to escape extremely high taxation at home, or it may respond to incentives deliberately created to encourage such movement. Both these objects have influenced United States investment in Canada, particularly since 1950 when that country reimposed an excess profits tax, and, to residents of that country, the petroleum industry in Canada has proved a most attractive opportunity for investment under the United States scheme of taxation. This subject is discussed more fully later.

Non-Tax Factors Having a Restrictive Effect on Canadian Investment in Equities

Just as there are non-tax factors affecting investment in Canada by foreigners, there are also non-tax factors which affect investment in equities by Canadians.

Broadly speaking, the institutions which hold the great bulk of the savings of the Canadian public are, with the sole exception of investment trusts, largely restricted by law or by tradition to investments other than equities of Canadian companies.

Canadian life insurance companies may not invest in common stocks to the extent of more than 15% of their total assets. The stocks which may be purchased are limited to those of companies having a certain minimum dividend history. These life insurance companies hold a large part of the savings of individuals, their total assets being some $5,568 million at December 31, 1953. At that date their investments in all stocks amounted to $302 million or about 5½% of total assets. No single company at that date had more than 11% of its assets in common and preferred stocks combined; thus there is no indication that the restrictive rules were having any positive effect at that time. However, the investment policy of life insurance companies in the postwar period has responded to a considerable degree to the requirements for housing construction. During the five years ended December 31, 1953 the assets of Canadian life insurance companies increased by $1,422 million and during the same period investment in mortgage loans increased by $763 million. The provision of these mortgage funds absorbed more than half of the new monies available for investment by these companies during this period.

The chartered banks are not restricted as to investment in equities as a matter of law, but as a matter of practice their assets (which totalled $11,533 million in 1954) must largely be employed in making loans and in providing reserves of the most liquid type in government and municipal bonds to meet their deposit liabilities.

Trust companies are subject to some restrictions, but, as in the case of the banks, the funds in their hands other than estate assets under administration are largely those of depositors. The nature of their obligations does not permit of any large investment in assets which can fluctuate widely in market value.

The pension funds of industrial and commercial organizations and of institutions represent a type of saving which has rapidly increased since the early years of World War II. It is now a condition of approval of such plans by the Department of National Revenue for income tax purposes that their investments be restricted to securities in which life insurance companies are authorized to invest—hence they may not include in total any greater investment in stocks than 15% of the fund. While not a statutory restriction for the protection of the employees, this is a present requirement of the taxation administration. A large part of these pension funds is invested directly in annuities issued by life insurance companies and such portion automatically comes within the life company limitations; a further large additional amount is invested in annuities of the Canadian government. At best, therefore, only a small part of pension fund monies is available for investment in equities of Canadian corporations. The total of pension fund investments is not known.[1]

[1]In his Budget Speech of March 20, 1956, the Minister of Finance indicated the intention of the Government to revise the general rules respecting pension funds. In particular, he indicated that the percentage limitations on equity investments would be removed.

Apart from institutional investment, one of the largest pools of money for investment is funds under the control of trustees, including funds administered under the wills of deceased persons. This is a matter which is regulated by the individual provinces. In Ontario the Trustee Act does not permit investment by trustees in equity securities: an executor is required by the end of the first year of administration to dispose of any non-trustee investments or run the risk of being held liable for loss on their realization. Investments are limited to bonds of or bonds guaranteed by Canadian federal, provincial and municipal governments or the government of the United Kingdom, first mortgages on real estate, guaranteed investment receipts of trust companies and debentures of loan companies and building societies. In practice, however, the restrictive effect of these provisions is being counteracted to a considerable extent by the growing trend, particularly on the part of wealthy individuals, to draw wills in such a manner as to grant considerable discretion to executors. Thus, many wills now specifically permit executors to retain non-trustee investments indefinitely and authorize the investment of estate funds in equities and other such securities.

The legislation regarding investments by trustees has also had a restrictive influence on investments by universities, colleges, hospitals, churches and societies of various kinds holding endowment or other investments, even though the legislation may have no application in their case. In the United States there has in recent years been a trend towards investment in equities of a substantial part of such funds and of pension funds. In certain cases endowment funds and pension funds have 50% or more invested in equities. As yet no strong trend of this sort is apparent in Canada.

Among investing institutions generally, the one class which is not severely restricted as to equity investment is the investment trust. These organizations invest heavily in equities, particularly Canadian common stocks and ordinarily have but a small proportion of their funds invested in bonds. While the total invested in these funds is substantial and is growing rapidly, it does not as yet represent more than a small proportion of the total savings of the Canadian public. At the end of 1954 the assets of 37 Canadian investment trusts and mutual funds whose statements are published in the Financial Post Survey of Industrials amount to almost $400 million. In addition, there is a number of closely held Canadian investment trusts whose statements are not published. The total of $400 million is not particularly large when considered in relation to the fact that trusts formed recently by United States investors have in a very few years raised more than $200 million of capital for investment in Canada.

The main source of equity capital in Canada continues to be the direct investment of savings by individuals and the re-investment of earnings by Canadian companies.

3

CANADIAN TAXATION OF NON-RESIDENTS

Effect on Canadian Corporate Income Taxes on Foreign Investment in Canada

One of the important tax factors, if not the most important, affecting foreign direct investment is the income tax on corporation profits. Of concern to the investor are both the rate of such taxes and the basis on which they are applied. Withholding taxes applied on remittances of corporate dividends and interest to foreign investors are of course also important, but the weight of such taxes is to a considerable extent reduced by reason of the fact that only a portion of the net profits is remitted, a substantial portion, often the greater part, being re-invested in the business.

(a) *Rates of corporate income tax:*

Since capital for international investment possesses considerable mobility there is competition for investment between capital importing countries and there is also a competition between any capital importing country and the country in which the foreign investor resides. Accordingly a comparison has been made of Canadian corporate income tax rates with rates in other countries. Such a comparison is difficult because there is no uniform method for computing income and there are many different types of tax structures—some countries impose excess profits taxes or use graduated rates of tax to a greater extent than others and some countries impose special taxes designed either to encourage or deter distribution to shareholders. The imposition in some areas of state and municipal income taxes and the application of surtax rates on profits from natural resources are additional factors which render comparison difficult.

From such studies as have been made, however, it is clear that the Canadian corporate rate is relatively high, being exceeded by the rates in relatively few countries, but it is to be noted that United States and German rates are higher. The Canadian rate is at present 47% (except on the first

$20,000 of income which is taxed at 20%). This rate may be considered to include provincial corporate income tax since a credit is given for provincial tax up to a 7% rate and the only provincial income tax now being imposed is a 7% tax levied by Quebec. (In practice the Quebec provincial tax may be considerably more or less than the credit allowed by the federal taxing authorities due to differences between the federal method of allocating income between provinces and the method used by Quebec.)

The United States rate of tax on income in excess of $25,000 is at present 52%; a reduction to 47% was scheduled to come into effect in 1955 but did not materialize for budgetary reasons and the President has now proposed that the reduction be again deferred. In addition, state taxes in that country average about 6%, but since they are deductible for federal tax purposes the effective net cost is about 3%, making a total of federal and state taxes combined of about 55%. A further point of interest in comparing the United States and Canadian rates is that the Canadian total of 47% includes 2% levied under the Old Age Security Act as a company's contribution towards the cost of providing old age pensions. In the United States the company's contribution towards the cost of social security (old age pensions) in those industries in which the employees are covered is at the rate of 2% of wages paid.

In 1950 and each subsequent year the United States corporate income tax rate has been substantially higher than the Canadian rate. (See page 28 for the United States rate of tax in the years 1950-53 inclusive. In 1954 and 1955 the rate was 52%.) Over a long period, however, the rates in the two countries have tended to fluctuate around the same levels. By contrast the corporate rates in some of the more important European, Latin American and Commonwealth countries are considerably lower than in Canada. The difficulty of comparing rates in countries with different tax structures has been referred to above.

It is also difficult to obtain an authoritative and up to date interpretation of the taxing statutes of foreign countries, but the following summarizes what is understood to be the corporate tax levels in the countries referred to:

European countries—

Italy—a rate including excess profits tax, varying from 20% to a maximum of 41%.

France—36% on profits not distributed and an additional 18% tax on the portion of profits distributed.

Latin American countries—

Brazil—rates totalling approximately 22%.

Venezuela—graduated rates up to 28½% with additional tax on profits from resource development.

Mexico—graduated rates up to 33% plus excess profits tax, which only in the most exceptional circumstances would bring the rate as high as the Canadian rate.

Commonwealth countries—

South Africa—25% plus a special tax on certain mining companies.

Australia—35%.

New Zealand—graduated up to a maximum of 43% plus 2½% Social Security Tax.

United Kingdom—

A standard income tax at the rate of 42½% on corporate profits to which must be added the minimum "Profits tax" on undistributed profits of 2½%, making a total of 45% on profits not distributed. When profits are distributed the Profits tax is increased by a further 25 percentage points, making a total rate of 70% on the portion of profits which is distributed.

(b) *Rapidity of depreciation allowances and other investment incentives:*

Apart from the rate of corporation tax, the rapidity with which capital expenditures may be written off by way of depreciation allowances is perhaps one of the most important factors influencing investment in corporations. The Canadian system is designed to encourage capital expenditures by accelerating the write-offs in three ways—

(a) The diminishing balance method adopted in 1949 permits writing off the greater proportion of the cost in the earlier years.

(b) The Canadian depreciation rates are much more generous than the rates in either the United States or the United Kingdom. The present Canadian diminishing balance rates are usually double the old straight line rates which were recognized as frequently being considerably greater than would be required on the basis of life expectancy, particularly in the case of machinery and equipment. By contrast, the rates in the United States are not fixed by statute or regulation but must be justified by reference to life expectancy, and in practice the rate of write-off in the United States has been considerably lower than the old Canadian straight line rates. Also the privilege recently granted in the United States of using the diminishing balance method at

double the straight line rates is restricted to assets constructed in 1954 and later years.

(c) The right under Canadian regulations to depreciate assets under construction permits of a further acceleration of the write-off which is of particular value in the case of major projects requiring several years to complete.

The annual rates of depreciation allowable in Canada are also substantially higher than the annual rates allowed in the United Kingdom. However, in recent years various incentives have been extended in Great Britain to stimulate investment in fixed assets. In 1946 a scheme of "Initial allowances" was adopted which permitted a substantial percentage (from 10% to 20%) of the cost of the asset to be written off in the year of acquisition in addition to the normal write-off. In 1949 these allowances were increased in the case of plant and machinery to 40%. Essentially "Initial allowances" merely permitted more rapid depreciation and did not increase the total amount claimable. In April 1954 they were largely replaced by a new plan of "Investment allowances" which offers a great incentive to invest in industrial plant and equipment. The Investment allowance is in the form of a tax credit equal to 10% of the expenditure on industrial buildings and 20% of the expenditure on plant and machinery. This tax credit is granted without affecting the right to deduct the full cost by way of depreciation allowances over the life of the asset. It provides a strong incentive to reinvest profits in new facilities which can best be appraised when considered in relation to the effect of the increased "Profits tax" of 25% on the portion of earnings distributed to shareholders. On profits distributed the total of Income and Profits tax is 70% but if profits are reinvested in plant the total tax on that portion of profits is only 25% if the investment is in machinery, and 35% if it is in industrial buildings.

(c) *Other corporate income tax features:*

Other features of the Canadian tax on corporate profits appear to have relatively little importance in their effect on foreign investment, at least, so far as "direct" investment is concerned. The absence of a capital gains tax in Canada has a very real effect on "portfolio" investment, as is discussed later herein, but it is probably not of great moment so far as direct investment is concerned. The most important class of capital profits made by corporations in the past have been those arising on the sale of fixed assets. Since the new scheme of depreciation allowances was adopted in 1949, which results in taxing "recaptured" depreciation (i.e. depreciation allowances since 1948 in excess of what is found to have actually been suffered), the freedom of corporations from tax on capital profits has become of considerably less importance. The full exemption from tax of inter-company dividends in Canada as against an exemption of only 85% in the United States is perhaps of less importance than would appear at first sight, because of the greater

ease with which mergers and amalgamations can be effected under United States tax laws.

The taxation of profits in the extractive industries presents entirely different problems, particularly depletion in the Canadian oil industry and the three-year exemption on new mines, both of which are discussed separately herein.

The greater simplicity of Canadian taxation as compared with the complexities of the United States scheme and the multiplicity of corporation taxes imposed by the various states is no doubt a helpful factor, but it is not a positive incentive.

(d) *Summary:*

To sum up, the conclusions as to Canadian corporate income taxes, apart from their effect on the extractive industries and on portfolio investment, are—

1. The rate of corporate income tax is relatively high and should tend to deter rather than encourage foreign investment, with the sole but important exception of investment from the United States where the rates of tax have been higher in each of the years 1950 to 1955. If the rate of corporate tax were the sole consideration, even United States capital would logically seek investment in many countries where tax rates are lower.

2. Apart from the rate of tax, the principal factor of corporate income tax likely to affect the foreign investor is the rapidity with which capital investment may be written off by way of depreciation allowances. The Canadian system provides a substantial incentive to the United States investor in this respect, but does not offer as great an incentive to the United Kingdom investor as do the recently adopted United Kingdom Investment allowances.

The Canadian Scheme of Taxation of Non-Residents

The taxation by Canada of non-residents is discussed below, insofar as it applies to income from investments and from carrying on business.

(a) *Taxation of profits from carrying on business:*

Where foreign corporations, individuals or partnerships carry on business in Canada they are treated, broadly speaking, in the same manner as Canadian residents, insofar as taxation of their income from carrying on business in Canada is concerned. The usual rates of tax applicable to individuals or corporations are applied to the income from the business and it is taxed separately from the income which these persons or corporations may have from other investments in Canada.

(b) *Withholding taxes under Part III of The Income Tax Act:*

Part III imposes a tax on income paid by residents to non-residents, which is computed separately from any other income tax payable under the Act. This tax is charged on income in the form of dividends, interest and rentals, as well as on certain other types of income which do not flow from investments. The rate of tax on investment income is 15%, with the following exceptions:

The tax is 5% on—

Interest on provincial government bonds (direct and guaranteed)

Dividends paid by subsidiaries which are wholly-owned (except directors' qualifying shares) by foreign corporations.

No tax is imposed on—

Canadian government bond interest

Interest on foreign currency loans payable to other than related creditors

Interest paid by "Non-resident owned investment corporations"

Dividends paid by "Non-resident owned investment corporations" if certain tests are met

Dividends paid by certain public utilities which qualify as "Foreign business corporations", where such dividend is paid to residents of the country in which the utility operates.

These taxes are imposed on the gross income without any deductions. A non-resident who is in receipt of rental income does, however, have the option of paying 15% on the gross rentals or filing a return and paying tax at the same rates as a resident on the net income after all deductions such as municipal taxes, repairs, interest on mortgages, insurance and depreciation allowances. The optional method in effect treats the ownership of property as though it represented the carrying on of a business.

The withholding tax on dividends is imposed only on payments by "resident" companies and in practice the Department of National Revenue interprets this as not requiring tax to be paid on any part of the dividends paid by companies incorporated outside of Canada, even though all or part of their profits may be earned from carrying on business in Canada through a Canadian branch or other enterprise.

The withholding taxes imposed by statute are modified in a number of respects by treaty. For example, under the Canada-United States treaty the reduced rate of withholding tax on dividends paid by wholly-owned subsidiaries is extended to 95% owned subsidiaries and under the treaty with Sweden the ownership qualification is further reduced to 50%.[1] Under the United Kingdom treaty no withholding tax is payable on dividends paid by wholly-owned subsidiaries of United Kingdom companies.

(c) *The level of withholding taxes:*

The rates at which Canada imposes withholding taxes are not greatly different from those imposed by the United States on payments to countries with which the United States has tax treaties. The United States statutory rate for withholding tax on dividends, interest and other periodic income is 30%, but this is reduced under numerous treaties to 15% and in the case of dividends paid by subsidiaries to parent companies it is reduced to 5%. The latter rate applies in the case of Canada, United Kingdom, Switzerland, Denmark, the Netherlands, Finland, Eire and New Zealand and the reduced 15% rate on dividends generally applies to these countries and to Germany, Belgium and Australia as well.

Canadian withholding taxes on non-residents are of a more recent origin than the Canadian income tax on residents. The Income War Tax Act was first enacted in 1917 but the withholding tax on non-residents was not imposed until 1933, the original rate being 5% (nil in the case of wholly-owned subsidiaries). In succeeding years the scope of the tax was gradually extended and in 1941 the rate was increased to 15%. In 1947 a tax at the rate of 5% was imposed on dividends paid by wholly-owned subsidiaries, which until that time had been free of any withholding tax. The legislation was also tightened in other respects. For example, until 1934 the scope of the exemption granted under Section 4K of the Act to companies whose income and business were outside of Canada was very broad and large numbers of such corporations were formed to hold investments for non-residents in order to take advantage of this. In 1936 this exemption was confined to companies such as Canadian corporations carrying on an active industrial, utility, mining or commercial business in a foreign country and to a very limited class of publicly-owned investment companies. At the same time, new legislation applicable to non-resident owned investment companies was introduced. The result has been a gradual reduction in the number of foreign-owned private investment companies, but within the last few years there has been a considerable movement of foreign capital into Canadian investment companies, such as the recently formed United States owned investment trusts referred to on page 19.

[1]In his Budget Speech of March 20, 1956, the Minister of Finance referred to the present ownership requirements for the reduced rate of withholding tax contained in the Canada-United States treaty, and expressed the hope that discussions at present being carried on with the United States Administration would result in the reciprocal lowering of these requirements.

(d) *Special types of companies:*

Investment companies which meet certain tests, including ownership by non-residents of at least 95% of the share capital and all of the bonds, debentures and other funded indebtedness, may elect to pay tax on a special basis which places the owners in much the same position as though they held Canadian investments directly. These companies are described as "Non-resident owned investment companies" and are known colloquially as "N.R.O." companies. In computing the taxable income of these companies no deduction may be taken from income except for dividends and interest received from other N.R.O. companies and for taxes paid to foreign countries. Dividends from Canadian companies which would ordinarily be exempt are thus made taxable. No deduction may be taken for interest on bonds or other indebtedness. The rate of tax imposed on taxable income computed in this manner is 15% and having paid this tax, dividends paid by N.R.O. companies are free of any withholding tax.

(e) *The use of Canadian corporations to hold investments on behalf of foreign owners:*

Canadian income tax legislation offers rather unique opportunities for foreign capital to accumulate income and capital gains on favourable terms involving no Canadian income tax or relatively little tax. This is due to the following, among other features, of Canadian income tax law—

1. Dividends from a Canadian corporation are ordinarily not taxable when received by another Canadian corporation. In the United States only 85% of a dividend received from another United States company is exempt in the receiving company's hands and the imposition of the full corporate rate on the remaining 15% amounts to a tax of about 7½%.

2. Dividends received by a Canadian corporation from a foreign corporation of which more than 25% of the fully voting shares is held by the recipient are free of Canadian income tax.

   There are no comparable provisions in the United States or United Kingdom income tax laws. Under the United States income tax law foreign dividends must be included in income and and are subject to United States tax, with a credit being allowed for any withholding tax deducted by the foreign country and, provided at least 10% of the company's stock is so held, an additional credit for the corporate income tax paid to the foreign country on the profits from which such dividends were paid. Where foreign corporate income tax rates are low and foreign withholding rates are low, this may result in substantial income tax becoming payable by United States corporations on income received from foreign investments.

3. No tax is payable in Canada on income accumulating in excess of a company's requirements, such as is imposed by the United States under Section 531 of the Internal Revenue Code of 1954.

4. No tax is payable on capital gains.

These factors have undoubtedly influenced one recent development, i.e. the formation of Canadian investment trust corporations, owned by residents of the United States, for the purpose of investing in diversified Canadian equities. If the investments of such companies are restricted to Canadian equities, they will, unless they elect to be taxed as N.R.O. companies, pay no Canadian tax on their income, although dividends paid would be subject to the usual Canadian withholding taxes of 15%. If they should have substantial income from interest or taxable foreign dividends (i.e. dividends from foreign companies which are less than 25% owned) they may elect to be taxed as N.R.O. corporations and pay a 15% tax on their total income; in this case no Canadian withholding tax will be payable on dividends distributed to their shareholders. A decided advantage accrues in these circumstances to the shareholders so far as United States income tax is concerned, in that income from equities and capital gains may accumulate in the Canadian investment company without the imposition of any immediate United States tax. The offsetting of capital gains against capital losses is also achieved, which is of some importance due to the limitations on the deduction of capital losses in the United States.

Some of these companies have indicated an intention not to pay dividends, but are so organized that the investor may have his shares redeemed by the corporation on demand. He then receives a return of capital, accumulated income and accumulated capital gains, all of which, from the United States tax point of view, are treated as a return of capital subject to tax only at the capital gains rate (a maximum of 25%) on the excess of the amount received over his cost. While Canadian tax at 15% is withheld on the income portion of the distribution, the United States taxpayer is able to offset this against the United States capital gains tax payable. He is, therefore, in a much better position than if the same income had been received by him directly in the United States and taxed against him there at ordinary rates from year to year.

Because of United States tax laws which treat a foreign investment company controlled by fewer than 10 United States families in much the same way as a personal corporation is treated under Canadian law (the shareholders being taxed on the income of the company, whether or not distributed), this type of investment company is limited for the most part to investment companies owned by numerous shareholders. Canada loses no tax under this plan of operation, as compared with direct ownership by non-resident individuals, except that on income from Canadian dividends the tax

is postponed until the same is distributed as dividends by the comapny. These funds have in the past few years applied a substantial amount of capital to the purchase of Canadian equities.

Canadian tax laws also provide an attraction for corporations and residents of other countries to organize an ordinary Canadian corporation to hold their investments in foreign countries, particularly shares of foreign subsidiaries. As previously noted a Canadian company can receive foreign dividend income free of any tax so long as 25% or more of the foreign company's shares are held by the Canadian company. It is thus possible for residents and corporations of some countries to use Canadian corporations as recipients of dividend income and as a vehicle to reinvest the income, without involving the owners in income taxation in their country of residence until such time as the income is distributed as dividends. The usual Canadian withholding tax is, of course, payable as and when the income is remitted abroad and in this way Canada eventually collects some tax which would not be collected if the foreign investor held these shares directly.

The Combined Effect of Canadian and Foreign Income Taxes on the Income of Non-Residents from Canadian Dividends

It is difficult to generalize as to the manner in which Canadian corporate income taxes, Canadian withholding taxes and foreign income taxes affect the total tax burden of non-residents in respect of income from Canadian sources. It is particularly difficult to do so in the case of investment by foreign corporations since the weight of the burden depends not only on the levels of profit tax rates in Canada and abroad but also on the methods adopted by the foreign country for taxing income from foreign sources, including the scheme, if any, of credits for foreign taxes paid. This subject is of considerable complexity and is dealt with in the attached appendix D.

In both the United States and the United Kingdom dividends received by corporations abroad are, as previously stated, taxable in full and credits are allowed under certain conditions for withholding taxes and for profits taxes paid on the income from which the dividends are considered to have been paid. The extent to which duplicate taxation of profits will result and the extent to which the imposition of withholding taxes may increase the tax burden on the foreign corporate owners varies considerably. However, the conclusions on this matter as set out in Appendix D are briefly stated as follows:

i. United States individuals will, unless their income is relatively small, suffer no loss through the 15% Canadian withholding tax on dividends. It will be absorbed by deduction from United States taxes.

ii. Dividends received by United Kingdom individuals will be "grossed up" (i.e. increased to a notional figure representing the dividend plus the profits taxes which these dividends have already borne) and the recipient will obtain credit for the 15% withholding tax and for the profits taxes which have been added back in the process of "grossing up" the dividend. The extent to which these credits will be recovered as a deduction from United Kingdom taxes and the extent of the remaining tax liability, if any, will vary greatly depending on the size of the individual's income since United Kingdom rates are graduated.

iii. In the case of a subsidiary, 95% or more owned by a United States company, the present 47% Canadian corporate rate and the 5% withholding rate would exactly offset the present 52% United States corporate rate and no United States tax would be payable on receipt of the dividend.

If the company is less than 95% owned by the United States parent and the withholding tax is therefore 15%, no United States tax would be payable if the profits from which the dividend is paid have borne Canadian tax at the rate of 47%. However, the net return to the United States corporation would be reduced by a substantial part of the withholding tax which would not be recovered by way of tax credit.[2]

If the current United States rate were equal to or less than the rate at which the profits had been subject to tax in Canada, the parent company would be out of pocket for the full amount of Canadian withholding tax, whether it was 5% or 15%.

iv. United Kingdom rates at present total 45% on undistributed profits and there is an additional profits tax of 25% on distributed profits. Accordingly the gross United Kingdom rate will vary widely, depending upon the proportion of profits distributed. The extent to which Canadian corporate income tax and withholding tax are recovered against United Kingdom taxes otherwise payable will also vary widely—if no portion of the profits is distributed there will probably be no United Kingdom tax payable on receipt of the dividend, but if a large proportion of the profits is distributed, the United Kingdom tax will substantially exceed credits for Canadian tax.

It will, therefore, be evident that the effect of Canadian withholding and profits taxes on the total tax burden of non-residents presents a mixed pattern, depending upon the laws of the country of residence of the owner, or upon whether he is an individual or corporation and on other factors.

[2]In his Budget Speech of March 20, 1956, the Minister of Finance expressed the hope that discussions at present being carried on with the United States Administration would result in the reciprocal lowering of ownership requirements for the reduced 5% withholding tax under the Canada-U.S. treaty.

4

UNITED STATES TAXATION POLICIES AFFECTING UNITED STATES INVESTMENT IN CANADIAN AND OTHER FOREIGN ENTERPRISES

TAXATION developments in the United States in the postwar period have played an important role in stimulating investment abroad. In part this was deliberate government policy to encourage foreign investment, and in part it resulted from high taxation in the United States to finance the Korean war and rearmament expenditures which tended to drive capital into more favourable tax climates. Some of the more important developments are summarized below.

However, before dealing with those aspects which particularly affected foreign investment it may be useful to refer to some of the more important changes in United States taxation in the postwar period which primarily affected the taxation of domestic income.

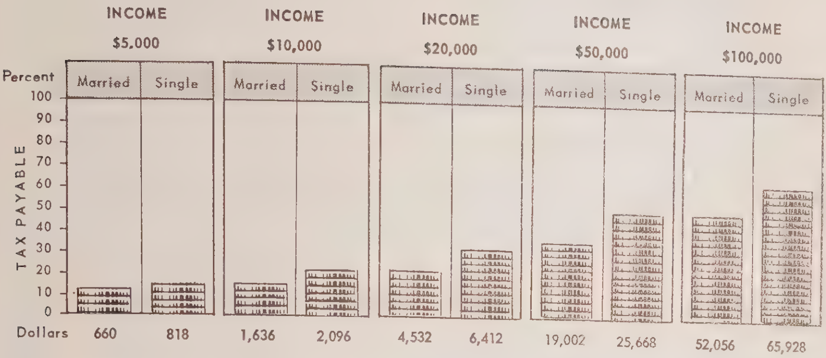
(i) *Expiry of Excess Profits Tax in 1945:*

The World War II excess profits tax law expired on December 31, 1945—two years ahead of the removal of this tax in Canada. This resulted in a very sharp reduction in the marginal rate of corporation tax (from 82% to 38%) and consequently increased the retained earnings of corporations. The reduced rate of 38% prevailed up to the end of 1949.

(ii) *Income Splitting Privilege:*

In 1948 an important change in the method of taxing the individual was adopted by permitting income splitting between husband and wife. Formerly this was allowed only in community property states. So far as married individuals were concerned this change, by increasing net income after tax, encouraged saving and investment. This advantage was equivalent to a saving of 20% or more of the tax formerly payable and the extent of the advantage enjoyed by married persons may be seen from the following comparison of taxes payable in 1955 by married and single persons respectively:

U.S.A. INCOME TAX 1955



NOTE: These figures are based on deductions of the smaller $1,000 or 10% of adjusted gross income for non-business deductions. They assume no dividend income.

(iii) *Amortization of Emergency Plant:*

Following the outbreak of the Korean war, the provisions for five-year amortization of certain plant facilities certified as necessary for national defence purposes were re-enacted. This had the effect of encouraging investment in new plant in the United States.

(iv) *Alternative Depreciation Methods:*

In 1954 alternative methods of depreciation allowances, designed to permit more rapid amortization of investment in plant were permitted. These included a diminishing balance basis at double the formerly applicable straight line rates but only available to amortize newly constructed assets.

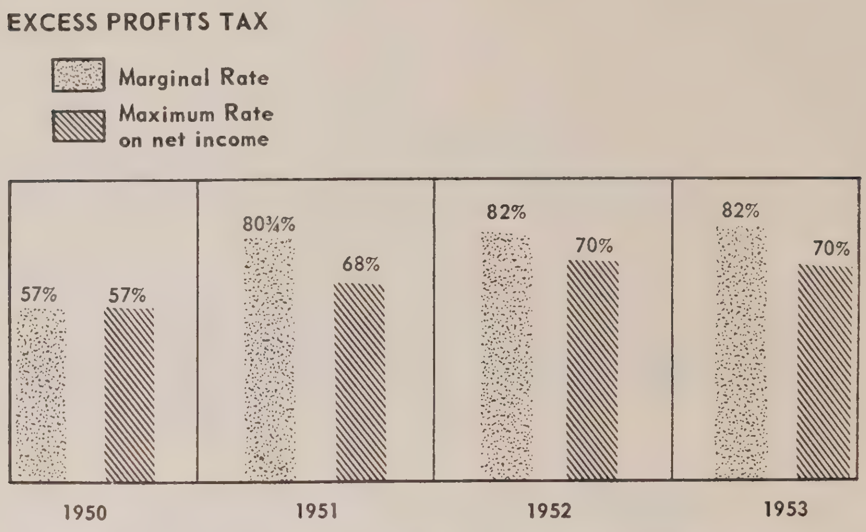
(v) *Dividend Credit:*

A scheme similar to the Canadian dividend credit was adopted in 1954, but this was limited to 4% of the amount of the dividend, which compares with 20% allowed in Canada.

The postwar developments in the United States having an important effect upon foreign investment included the following:

i. *The 1950 Excess Profits Tax*

One of the most important developments in this connection was the enactment of a new excess profits tax in 1950. This tax remained in force for the years 1950 to 1953 and was applied to the income in excess of a base computed on average earnings experience or invested capital. The combined income tax and excess profits tax rates produced high marginal rates of tax (over 80% in 1951-53) on income in excess of the base, but the severity of this was somewhat softened by the provision of a maximum over-all rate on total income. These marginal and maximum rates were as follows:



The enactment of this tax appears to have encouraged many United States companies to set up foreign trade subsidiaries. Not only were such subsidiaries exempt from excess profits tax, but this device permitted the diversion to such subsidiaries of other foreign earnings, otherwise subject to excess profits tax upon receipt by the United States parent.

ii. *Treatment of Blocked Earnings*

An additional factor influencing foreign investment was a ruling by the Internal Revenue Service in 1950 that blocked foreign income would not be taxable until it became freely remittable (even though earned and reinvested in foreign fixed assets or inventory, etc.)

iii. *Extension of Foreign Tax Credits*

In 1951 there was an important extension of the United States scheme of tax credits to corporations holding shares of foreign companies. Previously a United States company in receipt of a dividend from a foreign investment could obtain a credit, against United States tax otherwise payable, for the profits tax paid by the foreign corporation only in circumstances where the parent held 50% or more of the stock of the foreign company and, in the case of sub-subsidiaries, where 100% of its stock was owned and held by the subsidiary. These percentages were reduced to 10% and 50% respectively. This permitted much wider participation by United States domestic companies in joint foreign operations and had the effect of eliminating a duplication of corporate income tax in cases where the United States company owned more than 10% of the stock but less than a controlling interest.

iv. *Taxation Treaties*

During the postwar period, a number of additional treaties were negotiated with foreign countries and negotiations were initiated in other cases.

v. *Western Hemisphere Trade Corporations*

The practice of forming Western Hemisphere Trade Corporations under United States legislation existing since 1942 developed very substantially. This type of corporation is defined as a domestic company, all of whose business is in the Western Hemisphere, and at least 95% of whose gross income for a period of three years (or from incorporation) is from sources outside the United States, with at least 90% of the income being from the active conduct of a trade. A Western Hemisphere corporation is entitled to a reduction of about 27% of the United States income tax otherwise payable, making an effective rate of about 38% instead of 52%. This type of corporation as a vehicle for foreign investment is beneficial in several ways—

(a) Where the rate of profits tax in a foreign country is less than the United States rate, overall tax is reduced to the greater of the foreign rate or the Western Hemisphere corporation rate. This is of very considerable importance. It avoids the present anomalous situation in which a foreign country may tax profits at a low rate to encourage foreign investment, but the benefits of this concession are lost if and when the income is transferred to the United States and taxed at full rates less tax credits.

(b) The payment of foreign withholding tax is avoided in those countries (such as Canada) where such withholding taxes are imposed only on the payment of dividends by a domestic or resident company to a non-resident.

(c) The income of a Western Hemisphere trade corporation, being that of a United States domestic company, can be included in a consolidated return of a United States corporation. Furthermore the usual 2% increase in the rate as the price for consolidation is not payable in the case of such companies. This permits offsetting losses or development costs in early stages of a business against the income of a United States parent, provided there is a loss in the aggregate on the operation of all Western Hemisphere Trade Corporations so consolidated. This was of particular importance during the years 1951 to 1953 when the marginal rate of excess profits tax was in excess of 80%. To the extent that losses of Western Hemisphere trade corporations were offset against income otherwise taxable at these high marginal rates, the loss was largely absorbed as a reduction of taxes payable to the Treasury and only to a small extent out of the retained funds of the industry concerned.

It will be seen, therefore, that the Western Hemisphere Trade Corporation provisions represent a very important United States taxation incentive to foreign investment. Undoubtedly this form of organization is being used very extensively in two respects—

(a) In connection with development of natural resources such as petroleum where heavy development costs or losses can be expected in early years of operation, and

(b) To handle the export sales of United States manufacturers.

Studies which have been made by various agencies of the effect of this legislation indicate that it has not been conspicuously successful in establishing manufacturing industry in foreign countries.

vi. *Tax on Excessive Accumulations of Income*

For many years the United States has imposed a tax (now Section 531, formerly Section 102) on the accumulated taxable income of a corporation formed or used for the purpose of avoiding income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings to accumulate instead of being distributed. This tax has probably had some effect in stimulating investment abroad in order to avoid the necessity for distributions.

vii. *1954 Proposal to Extend Treatment Equivalent to Western Hemisphere Trade Corporation Status*

As a further indication of the trend of United States taxation policy, it is of interest to observe that the 1954 Internal Revenue Code as passed by the U.S. House of Representatives included a provision, rejected by the Senate because of technical difficulties, which would have had the effect of applying the Western Hemisphere Trade Corporation rate of tax, i.e. about 38%, to the profits of foreign branches of United States companies. The same treatment would also have been extended, subject to certain reservations, to all dividends and interest received from foreign corporations to the extent that they were paid out of earnings and profits accumulated after December 31, 1953.

Had this legislation become effective, branches and subsidiaries of United States industry operating abroad would have benefited from a reduction in tax in cases where the foreign rate on profits plus any foreign withholding tax amounted in total to less than the United States domestic rate. For example, if the foreign rate of tax were only 30% and the withholding rate 5%, dividends transferred to the United States would have become subject to additional tax of about 3%, making the total tax burden 38% instead of the present standard rate of 52%.

Thus the benefits of the low rate of taxation in the foreign country would, to a large extent, be passed on to the investor rather than, as at present, being lost in additional United States taxation. In the case of United States branches and subsidiaries operating in Canada, this reduction would have been largely of academic interest under present conditions, since the present Canadian profits tax rate (47%) plus the 5% or 15% withholding tax, equal or exceed the United States domestic rate in any event.

viii. *The Extractive Industries*

The combination of a number of the factors referred to above exert a strong influence on foreign investment in the oil and gas industry. This subject, of considerable importance and complexity, is dealt with in the immediately following section of this report.

5

THE TAXATION OF THE EXTRACTIVE INDUSTRIES IN CANADA AND THE UNITED STATES

THE DISCOVERY of major oil fields in Alberta in 1947 ushered in a very extensive programme of exploration and development in the petroleum industry in western Canada. To a large extent this programme has been financed and carried out by the major United States oil companies. During the same period United States interests have also been responsible for large developments in the iron ore industry in eastern Canada. Since these developments have occurred in fields where tax concessions are offered by Canada to induce investors to take the risks involved, the question arises as to the extent to which such inducements have been responsible for attracting the foreign capital which has entered these fields. The subject is one of major importance, but in a survey of this kind it is possible to deal with it only in broad outline. In the following paragraphs, however, the scheme of the Canadian incentives is discussed in relation to methods of taxation of extractive industries in the United States, which have probably to an equal, if not greater degree, stimulated the search for petroleum and other minerals in Canada.

An indication of the growth and extent of United States direct investment in these industries in Canada can be obtained from the following summary published by the United States Department of Commerce.

United States direct investment in Canadian industries

	Petroleum	*Mining and smelting*	*All other industries*	*Total*
		(Millions of dollars — U.S.)		
1943	$ 161	$384	$1,833	$2,378
1950	418	334	2.827	3,579
1953	933	677	3,632	5,242
1954 (preliminary estimate)	1,160	783	3,996	5,939

In both the petroleum and the mining and smelting industries, United States direct investment more than doubled in the four-year period 1950 to 1954. The investment in the petroleum industry is growing much faster than other classes of United States direct investment in Canada.

The attached Appendix E summarizes some of the more important features of the Income Tax Act which have special application to the petroleum industry. The following points are worthy of emphasis:

(i) The classes of taxpayers entitled to deduct both exploration and drilling expenses are extremely limited. Only corporations whose principal business is the exploration, marketing or refining of petroleum or natural gas, or mining, are entitled to these deductions. Companies engaged in other lines of business can of course incorporate subsidiary companies to explore and drill for oil, but the exploration expenses of such subsidiaries may not be offset against the income from other activities of the parent company. In effect, expenses of syndicates are in the same position in relation to the personal incomes of the individuals who own them. The deductions for drilling expenses incurred by an individual are very restricted.

(ii) The right to deduct exploration and drilling expenses constitutes merely a necessary deduction in the course of arriving at the net profit from the operation. However, the fact that these expenses may be deducted in any year, up to the full amount of available income of the taxpayer (including income from marketing, refining or mining) will almost inevitably result in a tax write-off over a much shorter period than the expected life of the wells. This provides a limited incentive to take the risks inherent in exploring for oil.

(iii) The deductible exploration expenditures do not include costs of property, except for Government leases abandoned as non-productive. To avoid the taxation of income in excess of what is realized, it is therefore necessary that the depletion allowance be sufficient to cover all of the non-deductible property costs. In addition the depletion allowance should give some recognition to the value of oil discovered and thus provide an incentive to take the risks of exploration.

Features of the United States Legislation which Facilitate Exploration in Canada by United States Interests

A brief summary of some of the more important differences between the United States and Canadian systems of taxation of the petroleum industry is given in Appendix F.

Some of the features of the United States scheme which encourage exploration in Canada by United States corporations are outlined below:

(a) For United States tax purposes, exploration outside the United States by a branch of a United States corporation is treated no differently than exploration within the United States. Accordingly, costs incurred in Canada relating to abandoned property and unsuccessful drilling (e.g. exploration costs, property bonus costs and intangible drilling expenses) are allowed in the same way as if incurred on exploration within the United States.

(b) The results of United States domestic subsidiaries may be consolidated with those of their parent companies, even though all of the business of such subsidiaries is carried on outside the United States.

(c) In the early stages of exploration in Canada the costs referred to in item (a) may be offset directly against other United States income in the case of a branch. In the case of a subsidiary, its losses may be offset in a consolidated return against the income of other operating companies in the group. Substantial relief is thus obtained against United States taxes which would otherwise be payable on non-Canadian income. This advantage is never lost. When the company reaches a profit position, its Canadian tax is not affected by the earlier recoveries made against United States taxes; and it will pay no more Canadian tax than a Canadian exploration company having the same amount of income and expenses in Canada.

(d) By carrying on operations in Canada through a United States Western Hemisphere Trade Corporation (which is taxed at a rate of only about 38%), a United States operator will in all probability not become subject to double taxation—the credits allowed against United States tax in respect of foreign taxes paid will almost invariably eliminate United States tax otherwise payable since the Western Hemisphere Trade Corporation tax rate is lower than the Canadian rate and the United States depletion allowances are much more generous.

These features of the United States law are favourable to the United States oil industry in its worldwide search for oil and stimulate investment in Canada as well as in other fields.

Criticism by the Petroleum Industry of the Canadian Taxation System

Any discussion by the industry of the Canadian system of taxing profits from petroleum development is invariably made against the background of

the United States legislation. This is a natural consequence of our proximity to the United States and of the very large participation by United States companies in Canadian exploration. It also stems in part from what the industry feels are competitive advantages which the American operator exploring in Canada enjoys as a result of the more favourable characteristics of the tax laws of the United States.

Strong complaint is made of the scheme of Canadian depletion allowances, which the industry feels are inadequate and fail to give the proper incentive to exploration. As will be seen from illustrations discussed later in this section, the United States depletion allowances are undoubtedly much more liberal than under Canadian law. The industry also feels that the United States allowances are basically more equitable, since the automatic allowance of the greater of cost depletion or percentage depletion gives a greater assurance of recovery of high cost acreage and costs of marginal wells. Perhaps the strongest criticism, however, relates to the failure of the Canadian taxing authorities to allow any depletion until all costs of exploration and drilling expenses have been written off against income (rather than allowing deductions for depletion as soon as there is any production from a property). This is said to result in a permanent loss of depletion allowances (rather than mere postponement) on the amount of production income which is offset by exploration expenses. The industry not only considers this inequitable, but they consider that it discourages further exploration—that a company would be better off to cease exploration and obtain greater depletion allowances once any property reaches a producing stage.

Apart from the depletion problem, the main criticism of the industry is probably as to the competitive advantage which a United States operator in Canada is said to enjoy as a result of more favourable tax treatment in the United States. In the early stages of a programme a United States operator is able to offset losses on Canadian operations against income otherwise taxable in the United States, thus substantially reducing his United States taxes otherwise payable. The advantage was particularly important several years ago when the combined income and excess profits taxes in the United States amounted to as much as 82% on a marginal basis. In these circumstances a United States operator in his exploration in Canada was largely risking "tax money" rather than his own investment. While this advantage is limited to the early stages of a programme, it is a permanent advantage which is not offset by payment of higher taxes in future years.

The more competitive position of the United States operator arises not only from the much more generous depletion allowances available immediately any production is reached, but also as a result of deductions allowable for property costs relating to unsuccessful exploration. In the view of the industry, the ability of the United States operator to deduct these costs in computing United States taxes otherwise payable permits him to outbid a

Canadian operator who is not entitled to the same deduction. This is no doubt correct, but the statement should be qualified as to the duration of such an advantage—basically it appears to obtain only during the period until the Canadian programme has sufficient production to offset the costs. Once a cumulative profit position is reached, Canadian taxes will assume the greater importance and a United States company will be on the same footing as a Canadian company.

While the industry does not appear to have stressed the point, a Canadian exploration company is under somewhat similar competitive disadvantages in relation to a Canadian marketing company. The right of the latter to offset exploration and drilling expenses against its marketing and refining income results in giving it "tax dollars" to use on exploration, which benefit is not shared by an exploration company. This situation continues until a net profit position on oil production is reached.

It should be observed also that the marketing and refining company has a further advantage in terms of the depletion available to it. To the extent that exploration and drilling expenses in the early years exceed production income and are therefore absorbed against income from marketing and refining, the net income from production in later years will be increased with a consequent increase in the depletion allowance. In comparison, the pure exploration company will become entitled to a lower aggregate of depletion allowances on production of equal value.

A third major criticism is the non-allowability of deductions for property costs, other than for original payments to the Crown for leases which have been abandoned as unproductive. No deductions are allowed for other property costs, with the exception of rentals up to $1 per acre per annum. This criticism is of significance not only in relation to the relative position of Canadian vs. United States interests, but also in absolute terms. It assumes greater weight in the light of the absence of any right to deduct depletion on the basis of cost of property, as an alternative to percentage depletion.

These appear to be the main points of dissatisfaction. Numerous criticisms of lesser importance are made, but it is not necessary or appropriate to explore them fully in a review of this scope.

Comparison of Canadian and United States Taxes Payable under Varying Circumstances

In an effort to draw some comparisons as to the effect of Canadian and United States tax legislation relating to exploration and development of the oil industry in Canada, detailed calculations were made of the United States and Canadian taxes payable in varying circumstances on what were considered to be more or less typical programmes, involving expenditures of about $1 million per annum for a period of ten years. So far as possible the assumptions as to the relationship of various costs, the success ratio from

drilling, the income and expenses from operations, etc., were based either on industry statistics or on what appeared to be reasonably representative assumptions.

The results of this study may be summarized as follows:

1. The fact that in the United States exploration costs relating to properties retained and the cost of well casing must be capitalized (both of which may be expensed in Canada), usually results in slightly larger deductions for exploration and drilling expenses under the Canadian system. However, this advantage may, depending on circumstances, be completely offset by deductions in the United States for bonus costs on acreage which is later abandoned.

2. Depletion allowances are undeniably much greater in the United States. The extent of the difference varies according to the type of programme which a company is carrying on. Also, there are differences in the depletion allowed to a Canadian company according to whether it engages only in exploration and production, or whether it has income from marketing, refining, etc. In one set of circumstances which was assumed, which is thought to be reasonably representative, the allowances over a period of years would have been as follows:

Depletion allowable for United States tax purposes	$3,729,000
Canadian depletion allowances—	
(a) To a company engaged only in exploration and production	1,463,000
(b) To a company having substantial income from marketing or refining	1,849,000

Calculating Depletion Allowances

Calculations were also made as to what the depletion allowances would be in other circumstances, assuming a programme involving more money spent on exploration and less on acquisition of property by bonus payments, and vice versa. While the United States allowances differed very little under the three assumed programmes, the Canadian allowances fluctuated considerably, being in some circumstances greater and in others less than the figures given above, but in each case being much below the United States allowances.

3. Over a ten-year period the net tax effect of the programme assumed in the study would be as follows—

(a) A United States company operating entirely within the United States would pay United States taxes of	$ 682,000
(b) A United States company which carried out the same programme in Canada, but which had other United States income, would pay combined United States and Canadian taxes on the income from the programme of	900,000
(c) A Canadian company having substantial marketing income, but no other production income, carrying out the same programme in Canada would pay taxes on the income from the programme of	1,195,000
(d) A Canadian company having no income from marketing or refining, etc., would pay taxes of	1,376,000

It will be seen that a United States company in these circumstances would, from a tax point of view, be considerably better off to carry on its operations solely in the United States, as indicated by the lower tax under item (a), and that our tax laws would not of themselves attract this capital in competition with United States fields.

On the other hand, a United States company operating in Canada (item (b)) would pay considerably less combined tax than a similar Canadian company, (item (c)) this advantage being due to recovery of United States taxes otherwise payable on its United States income in the early years. On the assumed facts the differential would amount to about $300,000. The saving all occurs in the early stages and is not increased or reduced once the programme reaches the profitable stage. On the alternative assumptions made, as to variations in the type of programme (i.e. more exploration or more land acquisition by bonus payments), the advantage was about the same. As between items (c) and (d) (both Canadian companies) the greater tax in (d) is due solely to lower depletion allowances.

Conclusions as to Taxation of the Petroleum Industry

There is probably no field of Canadian industry in which taxation considerations are more complex than they are in the petroleum industry. While certain conclusions may be indicated by a brief study of this kind, the form

and legal arrangements within the industry for joint ventures and acquisition of various types of property interests are so complex as to require a very detailed examination of the whole problem before reaching specific conclusions on which any change in legislation could satisfactorily be based. However, the limited study which has been made of the subject does indicate a number of broad principles which might be observed in dealing with the problem:

1. As in any other industry taxation should be imposed only upon the net profits. The system of allowances and deductions should be such as to give reasonable, if not absolute, assurance that all costs will be deductible, either directly or indirectly (such as through depletion allowances). Acquisition of land, exploration expenses and drilling expenses would all, in the absence of any right of deduction, represent capital expenditures. Our present legislation gives full recognition of the right to deduct exploration and drilling expenditures immediately up to the full amount of taxable income, but it does not, directly, allow deduction of property costs, with the exception of bonuses paid for unproductive government leases which are abandoned. Accordingly, under our present system the recovery of property costs can only be effected through depletion, but since the depletion system is based on percentage of income, rather than on cost, it does not in itself assure this result. Undoubtedly a system of cost depletion would provide greater assurance, but whether its over-all effect would be desirable or otherwise is a question which must be considered from many angles. Unless there were adequate safeguards, the immediate effect of introducing cost depletion would probably be to encourage the transfer of producing properties at values related to established oil reserves, so that the new owners would become entitled to a higher basis for cost depletion than existing owners. It would also raise serious administrative problems.

2. In addition to providing reasonable assurance of the recovery of costs in arriving at taxable income, investors will no doubt believe that our tax system should provide some incentive for taking the risks inherent in the industry. Presumably the incentives offered should logically be greater in the case of an exploration programme than for the development of proven acreage.

   Our present scheme of depletion allowances is therefore such that a single allowance, computed on income, must serve the two-fold purpose of allowing cost recovery and supplying incentive for risk-taking. It may be too much to expect that it will fill this dual role satisfactorily in the widely different circumstances which are found in the industry.

3. The depletion allowances should be on the same footing for an exploration company as for a marketing or refining company having other income. The latter now enjoy some advantage.

4. Any decision as to the extent of deductions for cost of property (now limited to abandoned Crown leases which prove unproductive) would have to depend upon the method adopted for dealing with the depletion problem. However, there are strong arguments for extending these deductions to include the cost of permits and reservations acquired from governments.

5. While it is important to reduce, as far as possible, the competitive advantage which non-residents may have over residents in exploring for oil in Canada, this can hardly be approached from the basis that the Canadian system must match the most favourable scheme of concessions granted by any foreign country whose operators engage in exploration in Canada.

It would be presumptuous to suggest a scheme which would meet these and possibly other basic requirements, and do full justice to the industry in all of the varying circumstances and forms of organization which are found. However, from the study which has been given to the matter, there are strong indications that the Canadian system of taxation would be improved by the adoption of a scheme of depletion allowances under which a major factor would either be gross income from production or income after operating expenses, thus discontinuing the present method of deducting all exploration and development expenses in arriving at the profit on which depletion is based. At least four advantages might well result from the change:

(a) Removal of the present dis-incentive to continued exploration after production has been obtained.

(b) It would go some distance towards making a Canadian company competitive with a United States company in the early stages of a programme.

(c) It would eliminate the present disability suffered by a pure exploration company, as compared with a marketing or refining company which obtains a higher base of depletion allowances through absorbing some of the exploration costs against the marketing income, rather than against the oil production income.

(d) As between exploration companies and those concentrating more on development of proven acreage, the greater incentive would be offered for taking risks.

However, in considering any new scheme of depletion, consideration would have to be given not only to incentives for exploration but also to the recovery of costs of acquiring proven acreage, including the investment which

has already been made in property at prices which were no doubt influenced by the present scheme of taxation. The whole subject is of such complexity that any major change should only follow a most detailed examination, with the fullest opportunity for the industry to make representations.

The Influence of the Canadian Scheme of Taxation on Ownership of the Mining Industry

The taxation of mining companies raises problems somewhat similar to those in the petroleum industry, in that special incentives are given to undertake the risks inherent in the venture. In addition to depletion allowances and rapid write-offs of exploration and development expenses, a three-year exemption from tax is given in the case of a new mine. There are also exemptions allowed to prospectors and others from tax on certain profits arising out of disposition of discovered property.

The extent to which foreign ownership of the Canadian mining industry has been influenced by tax considerations has not been the subject of discussion to anything like the same extent as in the case of the oil industry. It is also doubtful if the amounts spent in Canada by United States mining interests on exploration and development which would qualify for an immediate tax recovery in the United States have been more than a small fraction of the expenditures made by the petroleum industry (which may in part have been stimulated by United States tax allowances). Nor is it likely that the losses on abandoned mining properties have had anything like the same United States tax effects as similar losses on petroleum properties.

Since the legislation which permits deduction of development expenses in respect of petroleum is tied in with similar legislation dealing with mines (so that petroleum companies can deduct mine exploration expenses and mining companies may deduct costs of exploring for petroleum), the subject is one which should also be carefully considered in any detailed examination of the problem of depletion allowances, cost recoveries and incentives to the petroleum industry.

There is however one aspect of the situation which bears particular examination, i.e. the position of non-residents in relation to the three-year exemption from tax in the case of a new mine. When a new Canadian mine is owned by a non-resident corporation or by a subsidiary of a non-resident corporation, the effect of the exemption appears to be largely lost so far as the owner is concerned. The exemption from tax merely results in transferring the tax which would otherwise be payable on the first three years of operation from the Canadian government to the United States government. If the mine is operated by a United States corporation, the profits from the operation will be subject to United States tax immediately they are realized, notwithstanding the Canadian exemption. If, on the other hand, the operation is carried on by a Canadian subsidiary, United States tax will fall on the

dividends paid from the profits as distributions are made, because, as previously pointed out, the United States legislation does not parallel Canadian legislation in completely exempting from tax dividends from foreign sources where 25% or more of the share capital is held by the recipient. The full amount of the dividend therefore would be taxable in the United States, subject to the usual credits for withholding tax and for any profits tax paid on the earnings from which the dividend was paid. But since no profits tax will have been paid on the earnings for the first three years, there will be no tax credit in respect of these earnings and the result must be to shift the tax from the Canadian treasury to the United States treasury. This aspect of the three-year exemption warrants detailed consideration and a decision should only be reached after giving full opportunity to the industry to record its views on this important topic.

6

ASPECTS OF CANADIAN TAXATION WHICH CREATE DIFFICULTIES IN THE CANADIAN OWNERSHIP OF COMPANIES

THE RATES of Canadian personal income tax, like those of most countries, are graduated and become progressively higher as income increases. With this type of taxation it will inevitably be felt that high rates of tax do not permit an individual to retain enough from income to increase his capital and that they therefore stifle initiative. In a considerable degree this is true.

Comparison is frequently made between the Canadian and United States tax structures and attention is drawn particularly to the privilege of splitting income between husband and wife and to the deductions allowed under the United States law for a number of items not deductible under Canadian law, such as municipal taxes on the taxpayer's home, interest on a mortgage on his home and gasoline and other taxes. Because of these and other differences in the method of calculation of income, it is difficult to make exact comparisons between the two countries.

The problem is further complicated by important differences between the Canadian and United States credits against tax in respect of dividend income. Where dividends do not form any appreciable part of the recipient's income, personal income tax is generally slightly less in Canada in the case of a married person, even after giving effect to the new splitting privilege in the United States, if the income is less than about $10,000. The tax then becomes higher in Canada until a level of about $100,000 is reached. The effect of the income splitting privilege is, as indicated on page 22, to reduce the taxation of a married person substantially as compared with that of a single person and the taxation of a single person in Canada is generally lower than on a resident of the United States. If, however, any substantial part of the income is from dividends of domestic companies, the comparison becomes much more favourable to Canada. This is the result of the Canadian

dividend credit of 20% which goes far toward eliminating double taxation of corporate profits.

While Canadian rates of taxation are graduated fairly steeply and Canada, along with Great Britain and the United States, ranks as a "high tax" country, a consideration of the Canadian system of income taxation as a whole leads to the conclusion that it contains certain important features which encourage the ownership by individuals of Canadian (but not foreign) equities. The following are the principal such provisions:

(a) *The 20% dividend credit:*

This credit is a deduction from tax of 20 percentage points on the income (less any carrying charges) from Canadian dividends received by individuals. While this credit does not go as far as the United Kingdom system towards the elimination of double taxation, the relief afforded is very substantial as compared with the 4% credit now allowed in the United States.

As a result of this credit, a person with a small or moderate income, all of which is from dividends, may pay no tax other than the 2% old age security tax which never exceeds $60. For example, a married man over 65 years of age, whose charitable donations and unusual medical expenses entitle him to deductions totalling 10% of his income, and whose income was solely from preferred and common dividends of Canadian companies, could receive a total of about $16,200 of income without paying any personal income tax other than the $60 old age security tax.

On the other hand, the rate of tax on income in the highest bracket (income in excess of $400,000), which amounts to 82% including the 4% investment income surtax, is reduced in the case of dividend income by 20 percentage points to 62%. The net proceeds of dividend income after tax are therefore as least 38%, even in the highest income bracket; by comparison, the highest marginal rate in the United States, applying also to income in excess of $400,000, is 91% against which the dividend credit amounts to only 4%, leaving a net marginal rate of 87% and a return to the investor after tax of only 13%.

(b) *The Section 105 option to pay tax at 15%:*

An additional relief which Canadians may enjoy in respect of the taxation of income from dividends stems from the option under Section 105 of the Act which permits, on payment of a 15% tax, the capitalization and subsequent distribution through preferred stock redemption, free of any personal tax, of an amount equal to 85% of the undistributed income on hand at the end of 1949. Companies which have so capitalized their 1949 undistributed income or which had no undistributed income on hand at the end of 1949 have the further right to elect and pay a 15% tax on an amount equal to dividends paid in 1950 and subsequent years and thereafter to

capitalize and distribute the same without tax on the recipient. If a company avails itself of this additional relief, the maximum tax on distribution can never exceed 38½% of the amount so distributed (one-half at 62% and one-half at 15%). If the taxpayer is in the $25,000 to $40,000 bracket, the tax on distribution relative to that bracket will be 23½% (one-half at 32% and one-half at 15%).

This option has been availed of fairly extensively by private companies but its application is limited due to the fact that the tax is payable by the company rather than by the shareholders. Where there are shareholders who do not benefit from the payment of the tax such as non-resident owners or taxpayers who are exempt from tax on dividends, (Canadian corporations, charities, or individuals with small incomes), it may not be practicable to follow this course.

(c) *Capital gains:*

These are not subject to tax. Any appreciation realized through holding equities is thus tax free.

(d) *Investment trusts:*

There is relatively little double taxation on income from companies which qualify as investment companies under Section 69 of the Act. The opportunity is thus provided for the small investor to invest in equities managed and held by a corporation with no increase in his taxation. The corporation receives income from Canadian equities free of tax and the tax on interest income and on dividends from foreign sources is limited by statute to a reduced rate of 20%. In most cases this will be effectively recovered by the shareholder through the dividend credit of 20% to which he is entitled. However, to qualify for this reduced rate of tax 85% of the company's income must be distributed each year and this may be considered a deterrent to shareholders who are seeking growth opportunities.

(e) *Inter-company dividend exemption:*

Full exemption is allowed on dividends from one Canadian corporation to another subject to certain exceptions where designated surplus is involved, as referred to later herein. As has already been pointed out, in the United States only 85% of inter-company dividends are exempt.

(f) *Taxation of distributed vs. undistributed profits.*

The Canadian Act is basically neutral in relation to a corporation's dividend policy. It does not impose any tax on accumulations of income which may be considered unnecessary, such as are imposed under Section 531 of the U.S. Internal Revenue Code and which has the effect of stimulating distribution. On the other hand, there is no penalty on making distributions such as is found in the additional profits tax at the rate of 25% on income

which is levied in the United Kingdom. There is thus complete freedom either to accumulate income or to distribute it without penalty.

The foregoing characteristics of the Canadian system are all calculated to encourage investment in equities and in certain respects they constitute stronger incentives in that direction than do comparable provisions in the laws of the United Kingdom and the United States. There are, however, a number of factors which exert considerable pressure in the opposite direction. These, including our succession duty system, tend positively to discourage ownership of companies by Canadians. These negative influences vary in importance. They are discussed hereunder.

(a) *Succession duties:*

The adoption of legislation which permits elections to capitalize income on payment of a 15% tax under Section 105 of The Income Tax Act, to which reference has already been made, was a recognition of the need to relieve a constant problem facing owners of private companies. This special taxation provision facilitated the withdrawal of funds from companies for the payment of succession duties and thus liberated, at moderate tax cost, funds otherwise locked in by reason of prohibitive rates of income tax on dividends. Undoubtedly it has been of great help to many individuals. However, this relief may not be available by reason of the composition of the share ownership as referred to on page 40. Also the expansion of the Canadian economy, in the five years since this legislation was introduced, has been at such a rate that a great deal of the accumulated profits of companies has been required for reinvestment in fixed assets and inventories, with the result that in many cases Section 105 has not solved the problem of providing funds for succession duties.

Concern as to the amount of succession duties and fear of inability to obtain these funds, particularly if the business continues to grow, has been one of the major factors in the transfer of ownership of many Canadian private businesses to foreign control. A large number of foreign businesses have located in Canada since the end of World War II: in many cases these companies have purchased an established Canadian business to act as a nucleus for their activities and succession duties have frequently been the Canadian owner's reason for selling.

The following table gives a comparison with United States estate tax of Canadian succession duties on three bases—

(a) The federal duty only (applicable in all provinces other than Ontario and Quebec)

(b) The combined federal and Ontario duty

(c) The combined federal and Quebec duty where husband and wife are separate as to property.

The estimates are based on an estate where the widow (age 65) is left a life interest in the whole estate and the corpus is divisible at her death equally between two adult sons. The comparison is as follows:

CANADIAN SUCCESSION DUTIES	AMOUNT OF ESTATE			
	$250,000	$500,000	$1,000,000	$5,000,000
FEDERAL ONLY	$42,011	$128,422	$320,944	$2,472,342
FEDERAL AND ONTARIO COMBINED	45,251	128,422	320,944	2,599,977
FEDERAL AND QUEBEC COMBINED Where husband and wife are separate as to property	48,506	141,711	390,472	2,486,171
UNITED STATES FEDERAL ESTATE TAX NO MARITAL DEDUCTION CLAIMED	47,700	126,500	303,500	2,430,400

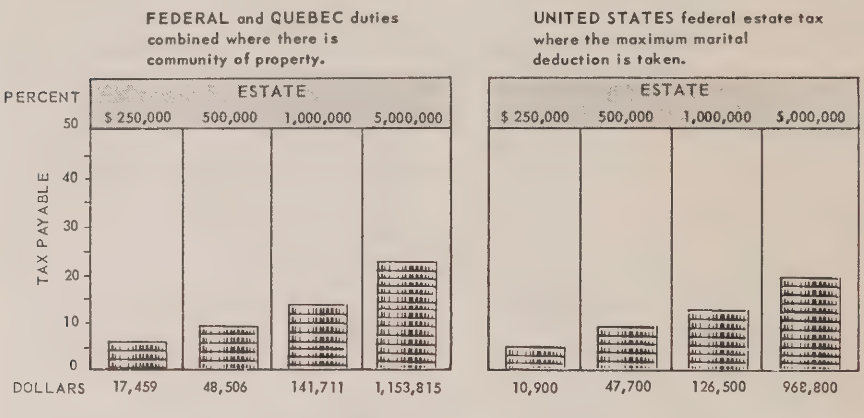
NOTE: In the United States succession duties are also imposed by numerous states but these as a rule are largely recovered by way of deduction from the federal estate tax.

It will be seen that there is a relatively close correspondence in the amount of duty payable in the various jurisdictions in the circumstances which have been assumed, particularly in the case of the largest estate.

There is, however, a very important feature of the United States taxation laws not reflected in the above comparison i.e. a marital exemption on all property bequeathed to the wife up to 50% of the estate. It is also important to note that in the province of Quebec unless the husband and wife are separate as to property, the doctrine of community of property applies. By this system the spouses become joint owners of their present and after acquired property with certain exceptions. During the marriage the husband in whose name the community property usually stands, alone administers it for the joint benefit and on the death of either spouse the community ceases and the property is divided equally between the husband and wife or their representatives. No claim for duty is considered to arise on the death of the husband in respect of the wife's share or interest in the community, her husband being regarded as a trustee for her of her share.

As a result of the specific provisions of the United States law and the operation of the community property law in Quebec where the parties have not contracted to be separate as to property, the duty payable on the death of the first spouse is greatly reduced. The duties for the same sized estates as

those for which the duties are quoted above would be reduced by more than 50% in Quebec where community of property exists and would be reduced to an even greater extent in the United States under a will in which the deceased bequeathed half of his property to his wife, viz.



In making these comparisons it should of course be realized that when a taxpayer in the United States bequeaths half of his property to his wife, or in Quebec where community of property exists, the amount of the estate which passes to the spouse, together with any increase or less any decrease in the assets of the spouse up to the date of her or his death, will become dutiable upon the death of the second spouse. Accordingly the total of succession duties on this property if and when it passes, say to the next generation, is not thereby reduced anything like the amount indicated. In total there would be some reduction in duty due to the fact that taxation in two stages reduces the rate of duty payable. The real significance of the American system and the Quebec system of community property is that, by deferring part of the succession duty problem until the passing of the second spouse, it is much easier for a man to make proper provision for his wife, which is frequently his chief concern, without having to face immediately the full impact of succession duties.

On the other hand, as will be seen from the table, the absence in Canada of a marital deduction in cases other than those where the Quebec community property status exists, results in a situation where the amount of succession duty which has to be raised presents a very formidable problem. If the estate is $5,000,000 approximately 50% will be payable in succession duties and if the estate is $1,000,000 the duty will be about one-third or more. Since many individuals who have founded a business have a large part of their assets invested in the business, it may well become necessary to sell the business in order to pay succession duties. Under the United States system or where community of property exists in Quebec, this sort of development is more often avoided.

(b) *Gift taxes:*

A related problem involves the imposition of gift taxes. In order to make it possible for a business to remain in the ownership of the family, an increasing number of individuals are taking steps during their lifetime to sell control of their business to their children before the succession duty problem becomes unmanageable. As a step in this procedure substantial gifts are usually made to the children to provide an equity with which to initiate the purchase. These gifts are subject to federal gift tax at rates ranging from 10% in the lowest bracket, to 28% where the total gifts in a year exceed the exemptions by more than $1,000,000. While gifts made more than three years prior to decease are exempt from federal succession duty, the imposition of gift taxes poses a problem because of the possibility of decease occurring within the three-year period.

Gift taxes are deductible from the federal succession duties otherwise payable on the gift, but they are not deductible from succession duties otherwise payable to Ontario or Quebec. Provincial duties are allowed against federal duty up to 50% of the federal duty total. Since the federal credit for provincial duty is limited to one-half the federal duty otherwise payable after deducting the credit for gift tax, the payment of any substantial gift tax by persons domiciled in either Ontario or Quebec may not be recovered from federal duty otherwise payable if death occurs within three years after making the gift. This presents an obstacle to the orderly distribution of property by way of gift prior to decease, which would not exist if credit were allowed for the full amount of gift tax paid within the preceding three-year period against the net Dominion duty otherwise payable.

(c) *The problem of "designated surplus":*

Under Section 28 of The Income Tax Act, when one company acquires control of another, dividends paid from undistributed income existing at the beginning of the year of acquisition lose their usual exemption when received by the controlling company and become taxable at ordinary corporation rates. In some circumstances it may be possible to escape the full duplication of corporate income tax, by making an election to pay the 15% tax under Section 105 of the Act on an amount equal to the 1949 surplus of the company. But in other circumstances it is not possible to avoid the duplication of corporate income tax at 47%.

These provisions regarding "designated surplus" increase the difficulty of retaining control of businesses in Canada since they create a substantial handicap for a Canadian corporate purchaser in buying control of existing Canadian companies. Until the 1955 amendments to the Income Tax law a Canadian corporation was in a much worse position than a non-resident purchaser in this respect, so far as Canadian tax was concerned and therefore was not fully competitive in buying a business.

The United States law does not contain any similar provisions and dissolutions of subsidiary corporations can be effected with much greater ease. A solution to this problem, with appropriate safeguard to the Revenue against loss of tax on ultimate distribution of undistributed income, would be a constructive step.

(d) *Borrowings by companies to acquire shares of other Canadian companies:*

Interest paid by corporations on borrowings to acquire shares of other Canadian companies is disallowed for tax purposes on the grounds that the related income from dividends is exempt from tax. Neither the United States nor the United Kingdom tax laws contain a comparable provision. Undoubtedly it is a deterrent to Canadian companies to expand by the purchase of control of other Canadian companies out of borrowed funds. While the principle followed (i.e. no deduction of expenses incurred to earn exempt income) is not in itself illogical, it should not be assumed that the Revenue would necessarily be the loser if the acquisition of businesses were financed by loans on which the interest was deductible. Interest received on such loans is taxable to the lender and the taxability is not affected by whether or not the deduction is allowed to the borrower. In various circumstances the Revenue would, if the interest were allowed, be in no different position than if the lender acquired the shares directly, instead of lending the money to another corporation to make the purchase.

(e) *Dividend credit on investments of profit sharing plans:*

The income tax authorities interpret the law as not permitting any dividend credit to be passed through to the beneficiaries of a profit sharing plan in respect of investment in shares of Canadian companies, even though the whole income of the plan must be taxed against the individual participants each year. In somewhat similar circumstances, e.g. in the case of an ordinary trust or estate, the dividend credit is allocated to the beneficiaries in the proportion in which they share in the income. The disallowance of the credit to participants in a profit sharing plan therefore seems inappropriate. An additional factor affecting these plants is that in its present form the special legislation contained in Section 79 dealing with taxation of these plans may imply that capital gains are taxable in the hands of the participants. While the practice of the Revenue Department up to date has been not to tax such gains, the absence of a clear exemption in the statute is a cause for some concern.[1]

The funds held under profit sharing plans are at present relatively small, but there is a growing interest in such plans and there is a definite tendency to invest in equities, either of the employer company or in a diversified list of stocks. There is a growing importance to the correction of these problems.

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[1]In his Budget Speech of March 20, 1956, the Minister of Finance indicated that these situations will be cured—capital gains will be excluded from the amounts taxable in the hands of the participants, and each participant will be entitled to the usual 20% dividend credit on his share of the income of the fund from Canadian dividends.

7

INTERPRETATION AND ADMINISTRATION OF CANADIAN INCOME TAX LAW

IT WAS suggested that the Commission would be interested not only in a recital of the several provisions of actual tax legislation, but also in observations as to the way in which Canadian tax laws have been interpreted and administered.

In making any comment on this subject, it is necessary to keep in mind the radical change in the whole approach to administration which was inherent in the new Income Tax Act in 1949. Prior to that time the law contained many discretionary provisions which were exercised by the Deputy Minister. While this permitted taking equitable considerations into account to a much greater extent than is now possible, it also introduced a much greater element of uncertainty as to the liability of the taxpayer. Under the 1949 Act the objective is to define, in the law or in regulations passed by the Governor General in Council, the conditions affecting taxability and to leave virtually no administrative discretions. The interpretation of the law is to be dealt with by the courts and the law is to be administered in the light of judicial decisions. This has necessarily resulted in a strictly legal, rather than an equitable basis of assessment of tax. For these reasons, it is perhaps unnecessary to say a great deal as to the manner in which the legislation is interpreted.

The method adopted under the new Act should in the long run result in greater certainty and more uniform application of the taxing laws, but this frequently takes time. For example, the interpretation of the law as to depletion allowances for the year 1949, involving the question as to whether the calculations should be made on a well-by-well basis or on an over-all basis (which is a point of considerable importance to the industry), has only just been decided by the Supreme Court of Canada.

Undoubtedly one result of the new scheme of administration which is of concern to many taxpayers is the gradual narrowing of the area in which profits are considered to be capital gains and therefore not taxable. This has caused particular concern in the field of investment in real estate by individuals, on the disposal by individuals of miscellaneous assets and in connection with realizations by corporations of various types of gain out of the ordinary course of business. Many of the decisions of the courts have resulted in subjecting to tax those gains which previously were considered non-taxable, and these horizons continue to narrow.

The other trend which is equally noteworthy is the gradual extension of the types and classes of expenses to be disallowed as not being laid out for the purpose of earning income. Under the old system such matters were rarely carried to appeal in the courts, but under the new type of administration a rule of law is established which has resulted in hundreds of cases being tried by the Income Tax Appeal Board or by the Exchequer Court. The issues dealt with in these cases cover a relatively wide field and a substantial body of precedent is being created which will be applied in the assessment of taxes in the future. However, from the practical business point of view, these decisions appear in many cases to be based on rules of law established many years ago and which are unrealistic in relation to present day business.

To a considerable extent, the rules followed by the courts in deciding what is capital and what is income appear to have grown out of decisions affecting the rights of life tenants and remaindermen, rather than being based on modern business concepts. Thus, many deductions are disallowed as being on account of capital, which bring neither permanent nor depreciable assets into existence, and which do not in any way reduce the obligations of a company. Examples of such disallowances are: costs of actions in the courts to determine a taxpayer's income tax liability, commissions paid to an underwriter on an issue of bonds (which represent only temporary borrowings and not permanent capital), costs of reorganization of the capital of a company under plans of arrangement or recapitalization, costs relating to the distribution of income after it is earned, and payments for rights having a value for a limited period of time.

In some cases the legal principles underlying these disallowances have been established in the case law of other countries for many years, but they are now receiving much wider application in assessments due to their adoption by the Canadian courts. From the standpoint of a proper determination of business income, many of these rules of law appear to be anachronistic and require either a modification of the broad rule as to the expenses deductible in arriving at income, or amendments to permit deductions of specific items.

To some extent the comments above regarding deductions apply to capital gains as well. The problem in this case is perhaps more difficult of

solution, but it is an area which requires serious consideration because of the sense of discrimination and uncertainty which now exists as between what is an income transaction and what is a capital gain transaction, when dealing with assets such as real estate or securities.

It would not be fitting to conclude these remarks without paying tribute to the administrative personnel of the several taxing authorities in Canada and, in particular, the income tax department of the federal government. A high standard of competence has been achieved and the public relations of the tax departments are most satisfactory.

APPENDIX A

ROYAL COMMISSION ON CANADA'S ECONOMIC PROSPECTS

Ottawa, July 18, 1955

J. G. Glassco, Esq. O.B.E., F.C.A.,
15 Wellington Street West,
Toronto, Ontario.

Dear Mr. Glassco:

I am writing to you as the current President of the Canadian Institute of Chartered Accountants to invite you to prepare for the Commission a study of the tax rates and policies in Canada, and such as may be relevant in the United States and the United Kingdom, since the war, which may have influenced investment in Canadian industry—

(a) to show how such policies have influenced investment in Canadian resource development and in Canadian industry generally; and

(b) the probable effect which such policies have had upon the ownership and control of Canadian companies, particularly in the more important industries (including the extractive industries).

In addition to a review of actual rates of tax, the study should include reference to such matters as:

(a) Accelerated depreciation allowances.

(b) Expenditures on drilling, etc., allowed as deductions for tax purposes, including U.S. Excess Profits Taxes.

(c) Tax concessions for "new mines".

(d) Rates of withholding taxes.

(e) Taxes exigible both in Canada and elsewhere on the winding up of Canadian companies.

(f) Exemptions of tax on inter-company dividends.

(g) Deductions from taxes payable by individuals with respect to income in the form of dividends, etc.

The study should include comment upon the effect which other legislation may have or may have had upon the investment of domestic capital in equity securities, e.g. restrictions upon investments by trust and loan com-

panies and pension funds, restrictions upon investments by insurance companies, and the traditional policies of management in this regard. It should refer also to other factors which may have influenced the investment of foreign capital in Canadian industry since the war (e.g. Canada is a safe as well as a close source for the U.S.A. for certain essential materials).

You will appreciate that the Commission will be interested not only in a recitation of the actual tax legislation in the three countries, but also in references to the way in which such legislation has been interpreted and administered, together with comments upon any special concessions or other considerations which may have influenced investment and developmental expenditures.

In addition to a factual submission which might be included with the published report or papers of the Commission, we should be interested in hearing, presumably during the course of the public sittings, any suggestions which may occur to you for changes in present policies which you think would be desirable in the interests of our natural development.

I may say that my fellow Commissioners were most gratified to learn that you might be willing to prepare a study along the lines suggested as a personal contribution towards the work which the Commission has undertaken. This will be a significant and important contribution in the public interest.

It might be helpful if we were to discuss this whole question in some detail after you have had an opportunity to give it some thought and to discuss it with your associates and others.

Yours sincerely,

(Sgd) W. L. Gordon

Chairman.

APPENDIX B

FOREIGN CAPITAL INVESTED IN CANADA AT SELECTED YEAR-ENDS, 1939 TO 1954
(Classified by type of security and by nationality of ownership)

(MILLIONS OF DOLLARS)	OWNED BY ALL NON-RESIDENTS				OWNED BY RESIDENTS OF UNITED STATES				
	1939	1945	1949	1953	1939	1945	1949	1953	1954
DIRECT INVESTMENTS (Controlled in country of ownership)									(Provisional estimate subject to revision)
BONDS AND DEBENTURES									
Steam Railways	49	46	37	36	41	38	29	29	
Other Corporations	322	281	336	584	265	254	310	554	
Sub-total	371	327	373	620	306	292	339	583	
Capital stock of Canadian Companies	1,502	1,860	2,541	3,924	1,289	1,613	2,200	3,329	
Other Corporation Assets*	423	526	672	1,433	286	399	556	1,268	
TOTAL DIRECT INVESTMENTS	2,296	2,713	3,586	5,977	1,881	2,304	3,095	5,180	5,700
PORTFOLIO INVESTMENTS (Not Controlled in country of ownership)									
BONDS AND DEBENTURES									
Steam Railways									
Controlled in Canada	1,158	795	688	580	393	457	351	258	
Controlled in Other Countries	2	2	2	3					
Other Corporations									
Controlled in Canada	265	220	168	369	173	158	133	344	
Controlled in Other Countries	5	60	68	131	2	2	9	9	
Sub-total	1,430	1,077	926	1,083	568	617	493	611	
Capital stock of Canadian Companies									
Companies controlled in Canada	1,105	1,249	1,275	1,615	354	462	580	852	
Companies controlled in Other Countries	83	85	98	146	13	13	16	26	
Other Corporation Assets*									
Companies controlled in Canada	9	16	14	39	8	13	14	38	
Companies controlled in Other Countries	2	6	4	11	1	1	3	7	
TOTAL PORTFOLIO INVESTMENTS	2,629	2,433	2,317	2,894	944	1,106	1,106	1,534	1,575
GOVERNMENT AND MUNICIPAL BONDS	1,703	1,662	1,755	2,087	1,221	1,450	1,534	1,870	1,822
MISCELLANEOUS INVESTMENTS	285	284	302	466	105	130	170	256	300
NEW INVESTMENT FUNDS									150
TOTAL NON-RESIDENT INVESTMENTS	6,913	7,092	7,960	11,424	4,151	4,990	5,905	8,840	9,547

* Includes net assets of unincorporated branches and other long-term investments.

SUMMARY

	1939	1945	1949	1953	1939	1945	1949	1953	1954
DIRECT INVESTMENTS	2,296	2,713	3,586	5,977	1,881	2,304	3,095	5,180	
PORTFOLIO INVESTMENTS	2,629	2,433	2,317	2,894	944	1,106	1,106	1,534	
GOVERNMENT AND MUNICIPAL BONDS	1,703	1,662	1,755	2,087	1,221	1,450	1,534	1,870	
MISCELLANEOUS INVESTMENTS	285	284	302	466	105	130	170	256	
TOTAL NON-RESIDENT INVESTMENTS	6,913	7,092	7,960	11,424	4,151	4,990	5,905	8,840	
PERCENTAGE OF NATIONAL OWNERSHIP TO INVESTMENT OWNED BY ALL NON-RESIDENTS FOR EACH YEAR	100%	100%	100%	100%	60%	70%	74%	77%	

SOURCE: Canadian Balance of International Payments and International Investment Position, Dominion Bureau of Statistics, International Trade Division, Balance of Payments Section. Issues for the year 1953 and 1954.

FOREIGN CAPITAL INVESTED IN CANADA AT SELECTED YEAR-ENDS, 1939 TO 1954
(Classified by type of security and by nationality of ownership)

(MILLIONS OF DOLLARS)	OWNED BY RESIDENTS OF THE UNITED KINGDOM				OWNED BY RESIDENTS OF ALL OTHER COUNTRIES			
	1939	1945	1949	1953	1939	1945	1949	1953
DIRECT INVESTMENTS (Controlled in country of ownership)								
BONDS AND DEBENTURES								
Steam Railways	8	8	8	7				
Other Corporations	44	13	13	15	13	14	13	15
Sub-total	52	21	21	22	13	14	13	15
Capital stock of Canadian Companies	194	226	309	465	19	21	32	130
Other Corporation Assets*	120	101	98	124	17	26	18	41
TOTAL DIRECT INVESTMENTS	366	348	428	611	49	61	63	186
PORTFOLIO INVESTMENTS (Not Controlled in country of ownership)								
BONDS AND DEBENTURES								
Steam Railways								
Controlled in Canada	736	306	305	290	29	32	32	32
Controlled in Other Countries	2	2	2	3				
Other Corporations								
Controlled in Canada	80	46	22	12	12	16	13	13
Controlled in Other Countries	2	57	57	122	1	1	2	
Sub-total	820	411	386	427	42	49	47	45
Capital stock of Canadian Companies								
Companies controlled in Canada	660	691	599	615	91	96	96	148
Companies controlled in Other Countries	55	56	64	83	15	16	18	37
Other Corporation Assets*								
Companies controlled in Canada	1	2		1		1		
Companies controlled in Other Countries	1			2		5	1	2
TOTAL PORTFOLIO INVESTMENTS	1,537	1,160	1,049	1,128	148	167	162	232
GOVERNMENT AND MUNICIPAL BONDS	453	157	171	150	29	55	50	67
MISCELLANEOUS INVESTMENTS	120	85	67	116	60	69	65	94
TOTAL NON-RESIDENT INVESTMENTS	2,476	1,750	1,715	2,005	286	352	340	579

* Includes net assets of unincorporated branches and other long-term investments.

SUMMARY

DIRECT INVESTMENTS	366	348	428	611	49	61	63	186
PORTFOLIO INVESTMENTS	1,537	1,160	1,049	1,128	148	167	162	232
GOVERNMENT AND MUNICIPAL BONDS	453	157	171	150	29	55	50	67
MISCELLANEOUS INVESTMENTS	120	85	67	116	60	69	65	94
TOTAL NON-RESIDENT INVESTMENTS	2,476	1,750	1,715	2,005	286	352	340	579
PERCENTAGE OF NATIONAL OWNERSHIP TO INVESTMENT OWNED BY ALL NON-RESIDENTS FOR EACH YEAR	36%	25%	22%	18%	4%	5%	4%	5%

SOURCE: Canadian Balance of International Payments and International Investment Position, Dominion Bureau of Statistics, International Trade Division, Balance of Payments Section. Issues for the year 1953 and 1954.

APPENDIX C

DIRECT INVESTMENT IN ALL CANADIAN BUSINESSES, OWNED BY UNITED STATES AND UNITED KINGDOM INVESTORS FOR SELECTED YEARS 1939 TO 1953 CLASSIFICATION BY TYPES OF BUSINESS

(MILLIONS OF DOLLARS)	OWNED BY UNITED STATES INVESTORS				OWNED BY UNITED KINGDOM INVESTORS			
	1939	1945	1949	1953	1939	1945	1949	1953
MANUFACTURING:								
Non-ferrous metals	130	203	270	494	6	8	8	15
Non-metallic minerals*	112	133	279	505	3	4	15	27
Iron and Products	188	272	378	592	4	4	7	21
Wood and paper products	281	316	441	559	38	30	88	121
Vegetable products	96	140	182	262	61	60	68	86
Animal products	47	44	55	70	2	3	3	3
Textiles	20	28	38	43	18	26	30	40
Chemicals and allied products	88	118	185	266	21	19	26	42
Miscellaneous manufactures	22	31	52	65		2	5	26
TOTAL	984	1,285	1,880	2,856	153	156	250	381
MINING AND SMELTING*	198	255	331	1,104	29	22	17	17
MERCHANDISING	119	153	199	339	46	51	76	117
UTILITIES	399	359	375	412	15	16	17	16
FINANCIAL INSTITUTIONS	126	198	241	346	120	98	61	65
OTHER ENTERPRISES	55	54	69	123	3	5	7	15
TOTAL, ALL COMPANIES	1,881	2,304	3,095	5,180	366	348	428	611

* Investments in exploration and development of petroleum by companies engaged principally in refining and production of petroleum products are included in non-metallic minerals item of MANUFACTURING.

SOURCE: The Canadian Balance of International Payments and International Investment Position, Dominion Bureau of Statistics, International Trade Division, Balance of Payments Section. Issue for the year 1954.

APPENDIX D

The Combined Effect of Canadian and Foreign Income Taxes on the Income of Non-Residents from Canadian Dividends

The impact of Canadian and foreign taxes combined on the income of non-residents from Canadian dividends depends upon a number of factors;

1. The level of Canadian corporate income taxes,

2. The rate of Canadian withholding tax payable. (In the case of a corporate holder this depends on the degree of ownership and on the terms of any tax treaty with the country in which the owning corporation is situated),

3. Where the foreign owner is a corporation, the method adopted by the foreign country in dealing with income from foreign sources, e.g. whether it is exempt or taxable, and

4. The scheme of credits for foreign taxes allowed by the country in which the owner resides. Such credits may be limited to actual taxes withheld at the source, or credit may also be allowed for taxes paid on the profits from which the dividends flowed, or credits may only be allowed on a reciprocal basis.

The complexities of the situation can perhaps be best illustrated by comparing certain aspects of the taxation of foreign dividend income in Canada, the United States and the United Kingdom.

(a) *Canadian treatment of foreign dividends received by corporations:*

A Canadian company owning 25% or more of the shares of a foreign corporation pays no Canadian income tax on dividends received from that company. In such circumstances the tax burden borne by the owning corporation is determined by the rate of foreign profits tax plus any foreign withholding tax.

On the other hand, a Canadian corporation which owns less than 25% of a foreign company is taxable on the dividend received. Credit is given for withholding taxes imposed on the dividend but no credit is allowed for any foreign taxes paid on the profits from which such dividends are received. In these circumstances there is a duplication of Canadian corporate income tax and foreign profits taxes, but any withholding taxes are likely to be absorbed as a credit against the Canadian corporate income tax.

(b) *The United States system of taxing foreign dividends received by corporations:*

In the United States on the other hand, dividend income received by corporations from foreign companies is not exempt, regardless of the degree

of ownership: the full amount received is subject to ordinary income tax (although it was not subject to the recent excess profits tax). However, a tax credit is given against United States taxes otherwise payable for both foreign withholding tax and foreign profits taxes, provided at least 10% of the foreign company's stock is owned by the United States company. (This treatment is extended to provide a credit for profits taxes paid by a 50% subsidiary of a 10% owned company as well). Thus tax is imposed only to the extent that the United States rate exceeds the foreign corporate tax paid and the withholding rates. If the United States corporate rate is 52% and the profits have borne foreign tax at the rate of 47%, the combined tax burden on the owning corporation per $100 of profits would be as follows:

THE UNITED STATES SYSTEM OF TAXING FOREIGN DIVIDENDS RECEIVED BY CORPORATIONS

			15% WITHHOLDING TAX			5% WITHHOLDING TAX
PROFITS OF FOREIGN COMPANY			$100.00			$100.00
FOREIGN CORPORATE TAX (47%)			47.00			47.00
DIVIDEND			53.00			53.00
WITHHOLDING TAX			7.95			2.65
BALANCE RECEIVED			45.00			50.35
UNITED STATES TAX						
52% ON $53		27.56			27.56	
LESS FOREIGN TAX CREDITS –						
WITHHOLDING TAX	7.95			2.65		
CORPORATE TAX – 47% OF $53	24.91	32.86		24.91	27.56	
NET UNITED STATES TAX		NIL			NIL	
AMOUNT OF PROFITS			$100.00			$100.00
TOTAL TAX BURDEN						
FOREIGN PROFITS TAX		47.00			47.00	
WITHHOLDING TAX		7.95	54.95		2.65	49.65
NET AMOUNT available to the United States Corporation			45.05			50.35
NET AMOUNT which would have been available to the United States corporation if the income had been earned as trading profits in the United States i.e. $100 less $52 or			48.00			48.00

NOTE: The credit for the foreign tax is based on the rate of income tax to which such profits have been subject. For this purpose dividends are, generally speaking, deemed to have been paid out of profits in last-in, first-out order.

It will be seen that in these circumstances, the extent to which the imposition of withholding tax results in increasing the tax burden on the foreign investor depends on whether there is room to absorb such tax by reason of the foreign corporate tax rate being less than the United States corporate tax rate.

(c) *The United Kingdom system of taxing foreign dividends received by corporations:*

Income from foreign dividends received by a United Kingdom corporation is subject to the standard rate of income tax (42½%), the 2½% profits tax on profits not distributed and the 25% profits tax on the portion of profits

distributed as dividends, but a credit is allowed for foreign withholding taxes and foreign taxes paid on the profits from which the dividend was paid. Unlike the United States system (where the amount brought into charge is the actual dividend), the United Kingdom system requires that the dividend be "grossed up" to represent the gross foreign earnings from which the dividend was paid, before deduction of the foreign income taxes on those earnings. As compared with the United States system the effect of "grossing up" is that where the United Kingdom rate of tax exceeds the foreign profits tax rate and withholding tax rates, the amount of the marginal tax applied in the United Kingdom is increased.

(d) *The United States and United Kingdom systems as applied to individuals receiving foreign dividend income:*

The United States allows credit for foreign withholding or other taxes paid on the dividend itself but not for taxes paid on the profits from which the dividends were paid.

The United Kingdom on the other hand, taxes individuals in much the same way as corporations, so far as foreign dividend income is concerned. The dividends must be "grossed up" and the individual is allowed credits for profits taxes on the income from which the dividend was paid, as well as for withholding taxes.

(e) *Summary of the present position:*

It is difficult to generalize as to the effective application of foreign tax credits. Dividends may be deemed to have been paid out of current earnings and to have borne the current rate of foreign tax, or they may be considered to have been paid out of prior years' earnings and to have borne some different rate of foreign tax. There are also complexities in the United Kingdom law in the treatment of income in the first few years in which an investment is held, which affect the application of foreign tax credits. The following may however give some indication of the position—

i. United States individuals will, unless their income is relatively small, suffer no loss through the 15% Canadian withholding tax on dividends. It will be absorbed by deduction from United States taxes.

ii. Dividends received by United Kingdom individuals will be "grossed up" (i.e. increased to a notional figure representing the dividend plus the profits taxes which these dividends have already borne) and the recipient will obtain credit for the 15% withholding tax and for the profits taxes which have been added back in the process of "grossing up" the dividend. The extent to which these credits will be recovered as a deduction from United Kingdom taxes and the extent of the remaining tax lia-

bility, if any, will vary greatly, depending on the size of the recipient's income, since United Kingdom rates are very steeply graduated.

iii. In the case of a subsidiary, 95% or more owned by a United States company, the present 47% Canadian corporate rate and the 5% withholding rate would exactly offset the present 52% United States corporate rate and no United States tax would be payable on receipt of the dividend.

If the company is less than 95% owned by the United States parent and the withholding tax is therefore 15%, no United States tax would be payable if the profits from which the dividend is paid have borne Canadian tax at the rate of 47%. However, the net return to the United States corporation would be reduced by a substantial part of the Canadian withholding tax which would not be recovered by way of tax credit.[1]

If the current United States rate were equal to, or less than, the rate at which the profits had been subject to tax in Canada, the parent company would be out of pocket for the full amount of Canadian withholding tax, whether it was 5% or 15%.

iv. United Kingdom rates at present total 45% on undistributed profits and there is an additional profits tax of 25% on distributed profits.

Accordingly the gross United Kingdom rate will vary widely, depending upon the proportion of profits distributed. The extent to which Canadian profits tax and withholding tax are recovered against United Kingdom taxes otherwise payable will also vary widely—if no portion of the profits is distributed, there will probably be no United Kingdom tax payable in respect of the dividend, but if a large proportion of the profit is distributed, the United Kingdom tax will substantially exceed credits for Canadian tax.

It will therefore be seen that the effect of Canadian withholding and profits taxes on the total tax burden of non-residents presents a mixed pattern and depends upon the laws of the country in which they reside, upon whether the owner is an individual or corporation and on other factors.

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[1]In his Budget Speech of March 20, 1956, the Minister of Finance expressed the hope that discussions at present being carried on with the United States Administration would result in the reciprocal lowering of the ownership requirements for the reduced 5% withholding tax under the Canada-United States treaty.

APPENDIX E

Special Features Applicable to the Taxation of the Petroleum Industry in Canada

Two special provisions of the income tax law which have particular application to the petroleum industry are the right to deduct exploration and drilling expenses and the allowances granted for depletion. These are discussed below:

(a) *Deductions from income for expenditures on exploring and drilling for oil and gas:*

The deductions permitted are restricted to—

(i) Corporations whose principal business is production, refining or marketing of petroleum, petroleum products or natural gas; exploring or drilling for petroleum or natural gas, or mining or exploring for minerals.

Generally speaking only expenditures incurred in Canada are deductible under this provision although, as discussed in item (iv) below, a limited deduction is permittted for the expense of drilling a producing well outside Canada.

The amounts deductible in any year are only limited by the available taxable income and are not restricted to income from production. Any balance may be carried forward indefinitely (unlike the limited loss carry-over allowed in other industries). Both productive and unproductive exploration and development expenses may be deducted. However, the allowable expenses are defined so as to exclude any payments in respect of land costs, other than rentals up to $1 per acre and bonuses paid to the Crown for an unproductive lease which has subsequently been abandoned for no consideration. The right to deduct is personal to the corporation which has made the expenditure and may not be assigned or transferred to another company acquiring the undertaking of the taxpayer nor to a company reimbursing the taxpayer for past expenditures or acquiring an interest in any of his properties

(ii) Associations, partnerships and syndicates formed for the purpose of exploring or drilling for petroleum or natural gas are allowed to deduct these expenses on the same conditions as the foregoing. The deduction is limited to the association's income but the same privilege of carrying forward indefinitely is available. Expenses so incurred cannot be offset against the income of an individual from sources other than the syndicate operation.

(iii) An individual drilling a well in Canada may deduct the drilling expenses (not exploration expenses) and such deductions are limited to the income from that well.

(iv) A very limited deduction for drilling expenses (but none for exploration expenses) is allowed to corporations and individuals who have income from oil or gas wells outside of Canada. The amounts deductible are the drilling expenses relating to each producing well up to the income from the well.

(b) *Depletion allowances:*

The other provision of major importance in the taxation of the petroleum industry is the right to deduct a depletion allowance, the amount of which is defined by Part XII of The Income Tax Regulations. A taxpayer who operates an oil or gas well may deduct from income an allowance equal to 33-1/3% of the aggregate of profits less losses for the year reasonably attributable to the production of oil and gas. (If the operator is also in the mining business the mining income, with certain exceptions, must also be brought into account). It is specifically provided that in arriving at the profits on which depletion is to be computed, deduction must be taken for drilling and exploration expenses allowed in the computation of income for the year. As a result an operator obtains no allowance for depletion until all drilling and exploration expenses incurred up to date have been fully deducted from income.

Persons other than operators (e.g. taxpayers who receive gross royalties) are entitled to a depletion allowance at 25% of the amount received and are not required to make any deduction for drilling and exploration expenses before calculating the allowance.

APPENDIX F

Major Differences Between United States and Canadian Taxation in the Petroleum Industry

The principal differences between the United States and Canadian systems of taxing profits from the petroleum industry may be summarized briefly as follows:

(a) Under the United States system, depletion is computed on a property-by-property basis rather than on an over-all basis as in Canada. As a result, depletion allowances become available as soon as production is obtained and are not affected by heavy exploration costs applicable to unsuccessful or uncompleted exploration.

(b) No provision is made in the Canadian legislation for depletion based on cost, the allowance being solely a percentage of net income. In the United States on the other hand, cost depletion is automatic when it exceeds percentage depletion. Greater assurance is thus provided of adequate deductions in respect of costs of high priced proven acreage or of marginal wells.

(c) Percentage depletion in the United States is based essentially on a percentage of gross income (27½%) but is limited to 50% of net income computed before, rather than after, exploration and drilling costs of other properties. This is referred to as being a "well-by-well" basis.

(d) The write-off allowed in the United States for costs of abandoned property is not limited as in Canada to Crown leases. All property acquisition costs such as bonuses must be capitalized (and therefore subject to cost depletion) but any unamortized balance may be written off if and when the property is abandoned.

(e) Deductions for exploration expenses are more limited in the United States in that—

(i) The carry-over of exploration expenses as a deduction from income is not for an indefinite period. It becomes part of the loss on the year's operations of the taxpayer and is thus subject to the same limitation as loss carry-forwards in an industrial business. This affects United States exploration companies adversely, but not companies with substantial income from other sources.

(ii) Exploration costs relating to leases acquired may not be written off as in Canada unless the property is abandoned.

(iii) The cost of casing in the well must be capitalized rather than expensed, but is subject to depreciation allowances.

(f) Intangible drilling costs including geological and geophysical costs of selecting drilling sites and roadmaking, etc., may be written off as in Canada, if the taxpayer makes an irrevocable option to expense these costs, which most taxpayers do.

APPENDIX G

OTHER STUDIES TO BE PUBLISHED BY THE ROYAL COMMISSION

Output, Labour and Capital in the Canadian Economy —
by Wm. C. Hood and Anthony Scott

Canadian Energy Prospects —
by John Davis

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The Commercial Fisheries of Canada —
by The Fisheries Research Board and The Economic Service of The Department of Fisheries of Canada

The Outlook for the Canadian Forest Industries —
by John Davis, A. L. Best, P. E. Lachance, S. L. Pringle, J. M. Smith, D. A. Wilson

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Canadian Secondary Manufacturing Industry —
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Some Regional Aspects of Canada's Economic Development —
by R. D. Howland

The Nova Scotia Coal Industry —
by Urwick, Currie Limited

Canadian Economic Growth and Development from 1939 to 1955 —
by J. M. Smith

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[1]This is one of a series of three studies on Canadian international economic relations prepared under the direction of S. S. Reisman.

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